C. K. Volkmann / K. O. Tokarski
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# Entrepreneurship in a European Perspective

## Concepts for the Creation and Growth of New Ventures

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# Foreword

One of the most frequently debated questions in management relates to what the reasons for success and failure of new companies, corporate initiatives and projects are. Obviously, to increase the rate of young enterprises' success while reducing the number of their failures would be a win-win situation for everyone. It is therefore vital to possess a "road map" or set of good advice on this never-easy undertaking. This book responds to such a need by presenting, in an accessible way, an overall view of the fundamental, critical areas of management of both the start-up and the continuity of new enterprises.

Primarily, this book is addressed to students and teachers of the growing academic field of entrepreneurship studies. However, in my opinion, it also has an appeal to students and academics in any scholarly field, for in our times we can well speak about an organic interdependence between "entrepreneurship" and "higher education and research". A number of reasons exist for this double-helix arrangement. On the one hand, it can be pointed out that the role and conditions of present-day higher education call for much more open and innovative ways with which to approach core tasks such as teaching, the organization of studies and the undertaking of research, not to mention the whole area of funding. On the other hand, societal expectations concerning higher education have greatly increased as societies are in high demand for:

- well-educated and culturally versatile and globally competent graduates who can be what I would call "able to work as self-directed professionals";
- research findings that can inspire technological innovations;
- well-studied analyses of our complex, global realities, as well as contributing to the finding of solutions for dealing with environmental challenges and societal changes.

In addition, we should also mention that modern universities are expected to be present in the local, regional, national and even international arenas as effective actors operating within the increasingly interdependent, interactive and vibrant setting in which our societies function.

I also think that this volume is to be recommended to leaders and managers of higher education institutions, in that a number of issues and solutions presented in the book can well apply to the management of universities and other higher education institutions. In particular, it is especially relevant for those universities that choose to follow the advice of thinkers on higher education, such as Burton Clark, and thus consider the need for a contemporary institutional model for higher education to reflect the notion of an "entrepreneurial university". Such a model of the university stipulates a strengthened steering core, an expanded developmental periphery, a diversified funding base, a stimulated academic heartland, and an integrated entrepreneurial culture, evidently, with due attention to needs for adaptation and refinement to national and local contexts and practices.

There are many definitions of "entrepreneurship" but one which I find particularly appropriate for higher education and research is one given by Giovanni Agnelli, late president of Fiat: "Entrepreneurship is the spirit of departing from being imitative, a willingness to take risks, a positive attitude to change and innovation. It is a job which is founded on a delicate mix of realism and passion and between the rationales and the driving force which comes from the vision of innovation". Every policymaker and top-manager who has been involved in the implementation of a major reform knows that it is easier to change structures than institutional cultures and individual behaviours. Thus, an "entrepreneurial thinking" in line with Agnelli's definition is gaining attention and understanding among varied members of academia.

A catalyst for this welcome development is work carried out by able teams, like that one led by Professor Christine Volkmann, who are committed to advocating and promoting entrepreneurial studies and an entrepreneurial culture within higher education institutions, both in Europe and in other regions.

Therefore, I am very pleased that UNESCO-CEPES, in a spirit of collaboration with Professor Volkmann and her team, have produced this very useful and timely publication.

*Dr. Jan Sadlak*

Director UNESCO-CEPES

## Authors' Preface

The present work has been written in co-operation with UNESCO-CEPES, which has provided a multi-national platform for a much-needed European entrepreneurship textbook, the purpose of which is to give a systematic, overall view of the fundamental areas of managing the start-up of young enterprises and their growth. Since there are also entrepreneurial challenges to be met as a new enterprise develops and grows, the discussion regarding the growth of enterprises is particularly close to our hearts, although we are aware that not all young enterprises want or are able to grow to the same degree. Because of this extended focus on the entrepreneurial growth of existing enterprises we have also included a number of examples of entrepreneurial activity in what are now large, multi-national corporations such as *Google Inc.* or *Apple Inc.* However, firms like this may still follow an entrepreneurial mindset, e.g., in the form of intrapreneurship, that is entrepreneurial behaviour within established firms. Moreover, these examples show that we have not exclusively relied on European enterprises; instead, where examples have been used for illustration, we have preferred to employ enterprise cases with which readers will be the most familiar.

The book is aimed at students and teachers in the field of entrepreneurship studies at universities and other institutions of higher education, with one core target group comprising of students of bachelor's and master's courses in all fields of study, while another target group includes founders and managers of growth enterprises. It is thus designed to assist in their studies both those who have already been trained in business management as well as newcomers to this field. It is important to us that entrepreneurial education should rank highly in the lives of people. As regards the teaching of entrepreneurship, we follow a Chinese proverb which says:

> *"If you plan for a year, sow rice, if you plan for a decade, plant trees, if you plan for a lifetime, teach people."*

We thank Stephanie Diergardt, Kathrin Lambrich, Tatsiana Varabei and Anna Weigandt for their helpful assistance in proof-reading the book and Miriam Thielemann and Eric Gilder for their indispensable help in English-language editing. We would also like to express our gratitude to Christiane Stüttgen and Sean Patrick Saßmannshausen who have provided their teaching material and expertise to better develop the added chapters for this English edition. Our thanks also go to UNESCO and UNESCO-CEPES as well as to the publisher, who continuously supported the creation of the book with patience and co-operation.

We wish all our readers success when working through this text and hope that our discussion of the theoretical concept of entrepreneurship and individual practical examples provided of young, growing enterprises will make their reading pleasurable and contribute to their fuller understanding of its meaning and application.

Such a work, however, never seems to be completed and we are thus involved in a continuous process of making future editions of this textbook better.

We therefore wholeheartedly welcome suggestions for improvement, from students and lecturers as well as from entrepreneurs and business managers. In particular, we invite readers from Eastern and Western Europe to join us in a rich, full discussion about the evolution of entrepreneurship across the continent.

Wuppertal and Bern, March 2010

*Christine K. Volkmann* *Kim Oliver Tokarski* *Marc Grünhagen*

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# 1 Basic Principles of Entrepreneurship

A well-functioning competition system in a market economy is made possible by a multitude and diversity of enterprises. Among them, recently-founded young enterprises are today considered to be the main important engines of economic, technological and social changes in the life of nations. Considering this aspect, innovative new enterprises form the nucleus of functioning market economy systems. From the political point of view as well, the subject of entrepreneurship, interpreted as entrepreneurial thinking and acting, has achieved a greatly improved status in the last few years. In Europe [within the framework of the reorientation of the Lisbon strategy formulated by the EU commission in 2005] the encouragement of entrepreneurial spirit in education and culture as well as supporting new business formation and promoting the growth of young enterprises have gained special significance. [A good overview of world-wide initiatives to promote entrepreneurial mindsets and activity in a broad sense can be found in a report on educating the next wave of entrepreneurs published by the World Economic Forum's Global Education Initiative; see Wilson (2009)]

Within this situation of high expectations, in which national economic policies place new enterprise formation above all else, entrepreneurs themselves are experiencing a change in the general political and social perception of and attitude towards them. It was, after all, true that from approximately the end of the sixties and right into the eighties, the **image of the entrepreneur**, for example in Germany, was not necessarily a positive one. In the context of Eastern European transition economies too, an understanding of the roles and functions of entrepreneurs has evolved and continues to form over time. [See Stephan et al. (in press) and Stephan et al. (2005) for a comprehensive study of attitudes towards and perceptions of entrepreneurs in Western and Eastern Europe.] This **rediscovery** of the entrepreneur as a key player and model in society runs more-or-less parallel to the boom in new enterprise formation and stock-markets of Western Europe, which occurred mainly in the last decade of the 20th century. [See Rovenpor (2004); and Timmons/Spinelli (2004), p. 4, who put entrepreneurs, and their role in creating economic growth and social benefits, centre-stage within American public policy.]

In political and public discussions, young, growing enterprises have become the bearers of hope in the **structural change** of a large number of economies [Carree/Thurik (2003)]. These expectations concentrate mainly on the creation of new **workplaces** [Koch (2001)], in that young enterprises are seen as the true engines of market economies. However, according to empirical studies, only some of the new enterprises



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founded can live up to these high expectations. The example of the USA shows that from 1993 to 1996 only five percent of young, fast-growing enterprises in the country generated 77 percent of the workplaces [Timmons (1999)]. Within the period 1994 to 1998, five million new workplaces were created by three percent of such young, fast-growing enterprises [Timmons/Spinelli (2004)]. These data mean that all young enterprises orientated towards dynamic growth are in a pioneering position to generate large numbers of new jobs. Finally, at the regional level, entrepreneurial activity appears to be an important mechanism to turn innovation efforts and knowledge generation into economic performance and growth [Audretsch (2007) and Audretsch et al. (2008)].

## 1.1 Start-up and Growth in the Context of Entrepreneurship

### 1.1.1 History of the Concepts of Entrepreneurship and Entrepreneur

The roots of the words and concepts of entrepreneurship and entrepreneur lie in the French language [Casson (2003); for the use of the term "entrepreneur" in 16th century France and later see Freiling (2006) and below] A later rediscovery of the German "Unternehmer" as entrepreneur took place in the works of the Austrian economist Joseph Schumpeter (1911), who is seen as the pioneer for the present discipline of entrepreneurship as an area of teaching and research. In the English edition of the much-acclaimed work "The Theory of Economic Development", Joseph Schumpeter translated the German concept "Unternehmer" as entrepreneur. [There are, however, authors who differentiate between the two, e.g., Drucker (2004).]

**Entrepreneurship**
Individual authors have found the first historic traces of the development of the concept entrepreneurship *as early as in the Middle Ages.* According to them, the typical entrepreneur of the Middle Ages was a cleric dealing with the building of large projects such as churches and castles without, however, taking any personal risks. [Hisrich/Peters (2002); Freiling (2006)] With regard to the discipline of entrepreneurship, general reference is made to the theoretical studies of the Irish economist Richard Cantillon (1680-1734), whose authoritative books were written between 1720 and his death in 1734. His posthumously published work, "Essai sur la Nature du Commerce en General" [Cantillon (1755)], is often quoted as a source in entrepreneurship literature. In his telling, entrepreneurship means independence, along with an ex-ante unknown remuneration and return on the investment. According to Frank H. Knight (1885-1972), entrepreneurs gain profits by taking and accepting insecurities (or uncer-

tainties) and risks [Gifford (2003)]. While risks can be calculated, uncertainties generally cannot be estimated. [For this and a comparison to Schumpeter's perspective on the risks of entrepreneurial activity and bank credit, see Brouwer (2000, 2002).] Joseph A. Schumpeter (1883-1950) describes entrepreneurship as the *implementation or realization of new factor combinations in the form of new products or new qualities of a known product, new production methods, the opening-up of new sales markets, new organizational forms* or *new forms of procurement.* These concepts of innovation and novelty form an integral component of his definition.

On the basis of Schumpeter's works, a *multitude of different entrepreneurship definitions* have been subsequently generated. In this context, we limit ourselves to consider only selected exemplary definitions and thereby dispense with a comprehensive and in-depth presentation. Casson (1982) concentrates his definition on the initial lack of resources available to the entrepreneur. According to Ronstadt (1984), entrepreneurship is a dynamic process oriented towards the step-by-step creation of property and prosperity. This prosperity is created by persons who are aware of their perceived risks as regards their invested capital and time expenditure, and, in accordance with their social position, feel bound to offer products or services in order to meet specific consumer needs within society. From this point of view, the product or service offered can be new or unique, but this is no must. However, the usefulness of the product or service must be generated by the entrepreneur in a certain form and should be protected and assigned to the product using all his/her necessary capabilities and means. In this concept, wealth creation through entrepreneurial action is brought to the fore, which is also typical of American perspectives on entrepreneurship.

A comprehensive definition of entrepreneurship within the meaning of a new value-creating entrepreneurial process comes from Hisrich (1985). His definition takes into account typical characteristics of entrepreneurial behaviour, which means that the entrepreneurial process requires time and effort and that the entrepreneur takes on financial, personal and social risks. However, the economic process hopefully results in the financial success as well as the personal satisfaction and independence of the entrepreneur. This definition illustrates that the concepts of entrepreneurship and entrepreneur cannot be considered separately, but are mutually dependent.

Hart/Stevenson/Dial (1995) describe the entrepreneurial behaviour of founders as dependent on their competence and industry-specific experience, with available resources representing a limiting factor. Rather, "entrepreneurship is a process by which individuals – either on their own or inside organizations – pursue opportunities without regard to the resources they currently control" [Stevenson/Jarillo (1990), p. 23]. According to Timmons (1999), entrepreneurship is based on an integrated approach within the meaning of an entrepreneurial value-creating process. Interpreted in this way, entrepreneurship refers to methods of thinking, argumentation and acting, which are characterized by the recognition and exploitation of entrepreneurial opportunities. In addition, entrepreneurship is characterized by limited employment of resources and the calculated taking of personal and financial risks, which are measured by the entrepreneur as exactly as possible in relation to the chances of success [Timmons (1999)]. In doing so, entrepreneurs are driven by commitment and perseverance.

In Table 1-1, some definitions of the entrepreneurship concept are listed as examples.

***Table 1-1:*** *Survey of definitions regarding entrepreneurship*

| Source | Definition of entrepreneurship |
|---|---|
| **Cantillon (1755)** | Self-employment with an uncertain return |
| **Knight (1921)** | Entrepreneurship means generating profits from bearing uncertainty and risks |
| **Schumpeter (1934)** | The realization of new factor combinations – new products, new services, new raw material sources, new production methods, new markets, new forms of organization |
| **Casson (1982)** | Entrepreneurship involves taking judgmental decisions about the coordination of scarce resources |
| **Hisrich/Brush (1985)** [original version]<br><br>[modified version in Hisrich/Peters (2002)] | Entrepreneurship is the process of creating something of value by devoting the necessary time and effort, assuming the accompanying financial, psychic, and social risks, and receiving the resulting rewards of monetary and personal satisfaction and independence |
| **Hart, Stevenson & Dial (1995)** | Entrepreneurship entails the pursuit of opportunity without regard to resources currently controlled, but constrained by the founders' previous choices and industry-related experience |
| **Timmons (1999)** | Entrepreneurship is a way of thinking, reasoning, and acting that is opportunity obsessed, holistic in approach, and leadership balanced |

Many definitions of the concept of entrepreneurship contain the following characteristic elements:

- Identification and exploitation of entrepreneurial opportunities
- Innovation and novelty
- Securing of resources and formation of an enterprise/an organization
- Profit-orientation taking into account reasonable risks and uncertainties. [Dollinger (2003)]

An essential factor for understanding the concept of entrepreneurship is the recognition and exploitation of entrepreneurial opportunities, with innovation and novelty referring especially to products or processes. Entrepreneurial activities are carried out target- and profit-oriented using scarce resources, thus engaging in entrepreneurial activity is associated with considerable risks for the entrepreneur, in particular the risk of new-venture failure.

Entrepreneurship can comprise personal, institutional as well as procedural dimensions. At the same time, the concept of entrepreneurship is by no means limited exclusively to institutions of the private economy. On the contrary, state institutions, too, such as state universities, can have an *entrepreneurial* orientation, for according to Peter F. Drucker, entrepreneurship is a type of behaviour and not a personal characteristic [Drucker (2004)]. In connection with the concept of entrepreneurship, the term *entrepreneurial spirit* is often used. Within Anglo-Saxon cultures, **entrepreneurial spirit** refers to a *mental attitude, defined by entrepreneurial characteristics* such as having innovative powers, dynamism, creativity, energy and drive as well as persuasiveness.

A comprehensive representation of the theory of entrepreneurship as well as of the research tendencies in this subject area is found, for example, in Fallgatter (2002) [see also Ripsas (1998)].

One often used characteristic form of the entrepreneurship concept is **corporate entrepreneurship** [for a detailed analysis of corporate entrepreneurship see Burgelman (1983); Guth/Ginsberg (1990), Covin/Slevin (1991); Sharma/Chrisman (1999); Frank (2006) etc.; also cf. chapter 1.1.4 below]. Corporate entrepreneurship includes all forms of entrepreneurial thinking and acting in large established enterprises, i.e. in form of *intrapreneurship* as well as *internal corporate venturing* and *external corporate venturing* [Burgelman (1983); Guth/Ginsberg (1990); Covin/Miles (1999)]. Well-known North-American enterprises practising corporate entrepreneurship are multi-national enterprises like Hewlett-Packard, General Electric, 3M or Xerox. A well-known product which is traced back to the idea of corporate entrepreneurship is the "Post-It" Note developed by 3M [Fry (1987), Sathe (1989)].

Generally speaking, the concept of corporate entrepreneurship is used in many and diverse ways and is not always uniformly distinguished from the term intrapreneurship. Many definitions of corporate entrepreneurship focus on the aspects of innovation and openness to change. Corporate entrepreneurship is also designed to promote financial success, as it is assumed that there is a positive relationship between corporate entrepreneurship and the financial success, which *must* be produced by innovations of the enterprise [Covin/Slevin (1991); Morris/Kuratko (2002); Antoncic/Hisrich (2001)]. The innovation claim also implicates the associated recognition and exploitation of entrepreneurial opportunities. At the same time, corporate entrepreneurship must be culturally and structurally anchored, strategically required and supported by personal and financial resources [Frank (2006)].

**Entrepreneur**

Similar to the concept of entrepreneurship, there is an equally broad spectrum of definitions for the concept of entrepreneur. At this point, the diversity of the concept will not be discussed in detail. [For more complete treatments of the term, see Schumpeter (1934); Gartner (1988); Barreto (1989); Elkjaer (1991); Hebert/Link (1988); Carton/Hofer/Meeks (1998); Hisrich/Peters (2002); Dollinger (2003); Drucker (2004); Hering/Vincenti (2005); Luger/Koo (2005).] Here, we will give a short, historical description of the understanding of this concept. As in the case of the concept entrepreneurship, theoretical discussions concerning the personality of the entrepreneur are often retraced to Cantillon. In his 1775 work "Essai sur la Nature du Commerce en General", he calls landed property the source of prosperity and distinguishes between three types of economic agents:

- The land-owner who is financially independent
- The entrepreneur who carries out the exchange of goods at his/her own risk and
- The person who is employed and has a fixed income.

Typical characteristics of the entrepreneur are, according to Cantillon, the readiness to take economic risks and the striving for profit.

With Schumpeter (1911) the focus of examination is enlarged by additional typical characteristics of the entrepreneur, in particular, powers of innovation and dynamism. Within this meaning, the entrepreneur is the driving force in the implementation and realization of *new factor combinations*. However, Schumpeter separates the concepts of inventor, discoverer or technician on the one hand from the entrepreneur on the other hand. These types are, in principle, to be analysed independently from each other. It is however possible that these development forms (inventor, discoverer, and also technician) can come together in the person of the entrepreneur who is also a technical inventor [cf. Brouwer (2002)].

Innovations continue to develop dynamically through a process of the so called creative destruction initiated by pioneering entrepreneurs; understood as the devaluation of still technically functioning products or services which goes hand-in-hand with the introduction of innovative products and production processes. This often occurs with new technologies, for they are disruptive technologies, by making existing products or technologies obsolete. In addition, creative destruction can refer to market structures or competition positions which have been drifting into a dead-end. From a theoretical perspective, this destruction is highly significant within a capitalist economic system, as the destruction process may provide an improved resource allocation and competitive activity in the end. [For possible exceptions because of technological "lock-in" effects, e.g., the VHS vs. Beta video system fight, see Liebowitz/Margolis (2002).] Thus creative destruction can also refer to the innovations of individual techniques or products as well as to whole markets or market sectors. There are many examples for new products; in the media sector, for instance, developments such as the CD and DVD have largely driven out tape and video cassettes from the market because of their competitive advantage. Accordingly, through discount super-market chains in the retailing and grocery sector (as, for example, *Aldi* or *Lidl* in Germany and across Europe) dead-end market structures and competitive positions have been challenged leading to a change in the entire business sector.

The entrepreneur is also often considered as a pioneer who plays an important role in the economy and society as a whole [for the socio-economic role of entrepreneurs see, e.g., Granovetter (2000).] The pioneer entrepreneur is the first to appear when innovations are required, and in the ideal case supports them in asserting themselves on the market. Entrepreneurial activities consist in overcoming existing hurdles as well as turning inventions into products through a combination of work and capital. Due to his/her close connection with innovations, the pioneer entrepreneur appears on the economic scene only intermittently. This characteristic is also part of Peter F. Drucker's succinct definition of the entrepreneur:

> *"[…] the entrepreneur always searches for change, responds to it, and exploits it as an opportunity." [Drucker (2004), p. 25]*

In practice, a distinct type of entrepreneur can be found, who indeed appears to search frequently for levers for change and novel business opportunities to exploit – the so-called *serial entrepreneur.* A **serial entrepreneur** is an entrepreneur who repeatedly founds enterprises, i.e. a series of enterprises. The serial entrepreneur is above all interested in the start-up, organization and (partially) also in the growth of enterprises within a usually short period of time. Various motives may be involved, e.g., *the enjoyment of putting ideas into practice, being creative, possessing self-sufficiency at the beginning of the enterprise development* as well as *correspondingly low enterprise complexity and staff numbers.* The latter is because with the growth of an enterprise, business complexity will increase and a change occurs from an entrepreneurial to a managerial perspective, with management activities (as well as administrative tasks) moving into the foreground. These are also possible reasons for a serial entrepreneur to sell the enterprise and to start again. In addition, *financial interests* can also play a role with a serial entrepreneur, e.g., as in the situation of fielding a lucrative takeover offer from a potential buyer. In this case, the decisive factor for success is the recognition and quick realization of entrepreneurial chances or opportunities [see also chapter 2.2]. An example of a successful serial entrepreneur is the Dutch entrepreneur Bert Twaalfhoven. By 2006, he had founded 54 enterprises in eleven countries over a period of 40 years. Although he failed with 17 enterprises, he never gave up, but consistently exploited the entrepreneurial chances available to him. The brothers Oliver, Alexander and Marc Samwer can likewise be seen as being on their way towards becoming serial entrepreneurs. The three men from Germany founded the internet auction platform *alando.de,* which in 1999 was sold to *eBay*. Subsequently the brothers founded *Jamba!*, offering ring-tones, pictures and videos for mobile telephones. In 2004, *Jamba!* was sold to the North-American company *VeriSign*. The three brothers have then recognized and exploited other entrepreneurial opportunities. Clearly, they are more interested in the enterprising idea itself than in exercising control over enterprises. A craving for managerial power within the enterprise was not their priority, as the founders handed over the management of *Jamba!* in 2005 and withdrew from the enterprise [Neubauer/Hogan (2006)].

These examples suggest that there may be differences between entrepreneurs and (traditional) managers [Stevenson/Gumbert (1985); see Busenitz/Barney (1997) for elaboration of these empirical differences; see also the discussion of the behavioural approach to entrepreneurship below]. In particular, entrepreneurship research has addressed the characteristics of entrepreneurs and the essence of entrepreneurship in terms of differentiating it from other activities like management or business administration, trying to understand the distinct role of entrepreneurs in the economy. This is reflected in three genuine approaches towards entrepreneurship to be discussed at the end of this section. All three approaches relate to the idea that being an entrepreneur has to do with the recognition and exploitation of new venture opportunities. This results in perspectives which (1) attribute distinct personality traits typical for opportunity discovery and exploitation (*traits approach*), (2) consider the entrepreneur to take on a specific role in society (i.e. entrepreneurs are the people who see opportunities and allocate societal resources to their exploitation; *functional approach*), and (3) distil out typical forms of behaviour relevant to capitalise on new venture opportunities rather than administering or managing existing business operations (*behavioural approach*).

Overall, the recognition and exploitation of an entrepreneurial opportunity is a process, which is considered to be market- rather than enterprise-orientated. [Note though that current effectuation research in entrepreneurship also addresses the possibility of entrepreneurial opportunity recognition the other way around, i.e., asking what *kind* of opportunities may exist on the basis of existing competences and capabilities of an entrepreneur; Sarasvathy (2001).] Recognition and exploitation of an entrepreneurial opportunity have been included in numerous definitions of entrepreneurs as a characteristic feature since the middle of the 1980s. A rather pragmatic, short and concise definition by Bygrave/Hofer (1991) shall serve as an example. The entrepreneur is a person who recognizes an *entrepreneurial opportunity* and exploits and follows it up with founding an enterprise. [For opportunity discovery, evaluation and exploitation as the three core elements of the entrepreneurial process, see also Shane/Venkataraman (2000).] This definition by Bygrave and Hofer illustrates that the entrepreneur and the formation of an enterprise stand in an immediate and direct relationship to each other within the process of entrepreneurship which, if successful, will involve enterprise growth unfolding over time.

Beyond this cardinal definition of the entrepreneur alongside his or her role in discovering and exploiting opportunities, three different strands of characterisations of who the entrepreneur is and what an entrepreneur does have evolved in entrepreneurship research (see Saßmannshausen, 2009 for a detailed discussion and comparison of the three generic approaches):

- (1) Traits approach (the psychology of entrepreneurs vs. other people in terms of personal characteristics, attitudes, and motivation towards entrepreneurship)
- (2) Functional approach (the role and output functions of entrepreneurs in the economy)
- (3) Behavioural approach (the actual behaviour of entrepreneurs defining the nature of what constitutes entrepreneurship)

(1) Since the fundamental studies of David McClelland in the 1960s, entrepreneurship researchers have concentrated on the characterization of ideal personality characteristics of entrepreneurs. The research approach of McClelland is based mainly on the so-called *Traits Theory* or *Traits School*, which deals with the study of specific characteristics of entrepreneurs in particular. [See McClelland (1961); McClelland (1965) and Kuratko/Hodgetts (2001) who put the traits school of thought in the context of alternative approaches at the micro-level, namely the venture-opportunity and the strategic-formation school.] According to the classical **traits approach**, the *entrepreneurial personality* can be seen *as the embodiment of all traits, properties and qualities of the entrepreneur as a human being*. According to McClelland, entrepreneurs have, for example, a pronounced need to perform well. According to Klandt (1984), the following personal characteristics can be ascribed to an entrepreneur: *striving for independence* (need of independence), *performance motive* (need of achievement), *readiness to take risks* (need of risk), striving for social advancement, *wish for recognition* (need of affiliation), *general attitude of independence, general and job-related value-priorities, striving for power* (need of power) [also cf. Bhide (2000); Timmons/ Spinelli (2004)]. Besides the typical characteristics of *performance motivation* and the inclination towards *calculable risks,* the *inner conviction to be in control*, i.e., "I as the driving force", is a characteristic with good validity [Fueglistaller/Müller/Volery (2004)]. It is important to note however that the traits approach has been criticized, in particular as "the search for a single psychological profile of the entrepreneur is bound to fail" [Stevenson et al. (1999), p. 5] and other competing approaches have come to the fore (again), e.g., the functional and behavioural approach [see the summary below and also cf. Hatten (1997) for a critical discussion of the traits approach].

Often entrepreneurs are also credited with an extraordinary readiness and capacity to learn [cf. Minniti/Bygrave (2001)]:

> *"Effective entrepreneurs are exceptional learners. They learn from everything. They learn from customers, suppliers, and especially competitors. They learn from employees and associates. They learn from other entrepreneurs. They learn from experience. They learn by doing. They learn from what works, and more importantly, from what doesn't work." [Smilor (1997), p. 344]*

A typical initial question for personality research is whether humans are born to be entrepreneurs, that is, born with the qualities of an entrepreneur that can be developed (or not). From here follows the important question whether humans can be educated to be entrepreneurs [Koch (2003)]. The question also arises in how far entrepreneurial characteristics can be influenced positively through education. In analysing such research questions (and defining and measuring relevant variables), numerous models have been developed on the basis of the traits approach, by which to measure personalities. In this context, the 16-primary-factors-model according to Cattell, the Big-Five model of McCrae and Costa and the Myers-Briggs-Type Indicators (MBTI) can be cited as examples. However, these models are not to be discussed in more detail at this point. [For more details Cattell (1973); Myers/McCaulley (1985); McCrae/Costa (1989); Costa/McCrae (1992) etc.]

These quoted models for identifying the personality characteristics of entrepreneurs are, however, not undisputed in the scientific discussion. A central aspect of the critique is that entrepreneurs are assumed to form a heterogeneous group of persons. Consequently it is, in principle, not possible to characterize *the* typical entrepreneur. [See Gartner (1988) arguing that asking who is an entrepreneur is the wrong question.] For this reason, the examination and search for person-related variables, with which to identify a person as entrepreneur, is not meaningful. It is therefore also impossible to describe *the* type of a successful entrepreneur. In essence, the critique aims at examining not the personality characteristics of entrepreneurs but rather their behaviour and actions. [For a detailed critique of the methods of studying personality characteristics, see, for instance, Gartner (1985); Gartner (1989); Drucker (2004).]

In connection with such personality research, the question often arises *which* typical characteristics of entrepreneurs determine the success of the enterprise. The aim is to detect the success-producing, ideal features of an entrepreneur. A basic problem of this research area is, however, *how* to prove a causal connection and the influence direction between personality characteristics and the success of an enterprise. In this context, diverse difficulties arise. In one view, often divergent approaches are applied when measuring enterprise success within the success-factor research. One of the problems is the direct assignment of the enterprise success to individual variables and sectors, such as, for example, the personality of the entrepreneur. However, it is not always possible to clarify the direction of effect. Thus, personality factors might well be responsible for the success of an enterprise, while, on the other hand, it would also be possible to explain that the success has an effect on the personality of the entrepreneur. All-in-all, the research results concerning the characterization of an entrepreneur with the help of individual properties, which have emerged in large numbers, to a degree clearly contradict each other. For these reasons such research approaches and research models are often subject to criticism [Stevenson/Roberts/Grousbeck (1994); Brockhaus/Horwitz (1986); Fallgatter (2005)].

(2) The **functional approach** reflects an economic perspective on entrepreneurship. As such it zooms in on the role entrepreneurs take in market economies, namely within the process of transforming resource inputs into (novel) product and service outputs. In particular, entrepreneurs are tasked with bearing and furthering innovation in a variety of forms. *Schumpeter's* concept of the pioneer-entrepreneur belongs to the func-

tional category and in terms of creating novelty Schumpeter "allowed for many kinds of innovation including process innovation, market innovation, product innovation, factor innovation, and even organizational innovation. [Stevenson (2006, 2); also cf. the discussion of Schumpeter's concept of entrepreneurship above.] And Stevenson further concludes (ibid.) that "his [Schumpeter's] work emphasized the role of the entrepreneur in creating and responding to economic discontinuities in the system". Similarly, *Kirzner's* (1973) notion of entrepreneurs' alertness to opportunities follows a functional rationale. Here, the entrepreneur serves to detect price differences in the market and to act as an arbitrageur. Note though that while Schumpeter considers the entrepreneur as someone who drives the market system away from equilibrium (namely by creative destruction in view of pioneer rents), Kirzner's arbitrage entrepreneur has more of a price signalling and balancing function contributing to market equilibrium. Building on these concepts, the more contemporary definition of *Shane and Venkataraman* (2000) stresses functional aspects too, consigning the entrepreneur with the tasks of discovering, evaluating, and exploiting entrepreneurial opportunities. [See also chapter 2.2 on entrepreneurial opportunity recognition below.] The functional approach shares some congruent aspects with the behavioural approach [cf. Saßmannshausen (2009)]. In a way the latter looks at the other side of the coin of entrepreneurship. [This is visible, e.g., when considering typical outputs of entrepreneurial activity – independence and personal wealth creation at the level of the individual entrepreneur and, correspondingly, value and wealth creation as well as contribution to economic prosperity at the societal level; see again Ronstadt (1984), Hisrich (19985), and Timmons (1999).]

(3) While the functional approach is concerned with the role of entrepreneurs in aggregate for the wider economy, the **behavioural approach** concentrates on what entrepreneurs actually *do* as individual actors. This approach is mainly related to the works and efforts of Howard Stevenson, e.g., Stevenson/Gumpert (1985), Hart/Stevenson/Dial (1995), Stevenson (2006). In brief, this strand considers entrepreneurship as an "approach to management" namely characterized by the fact that business opportunities are pursued regardless of the possession of the necessary resources [see, once more, Stevenson/Jarillo (1990)]. That is, entrepreneurship is not defined by the characteristics and attitudes of the entrepreneur as a person as in the traits approach which has been critically addressed above. Rather, within the behavioural strand, entrepreneurship is demarcated by displaying a specific type of behaviour as opposed to other forms of, e.g., administrative behaviour. More precisely, entrepreneurship is viewed in a continuum of managerial behaviour with the two ideal-types of promoter (within the entrepreneurial domain) and trustee (leaning more towards the administrative domain). In Stevenson's view, this conception of a continuum or spectrum of behavioural dimensions is necessary for defining entrepreneurship because otherwise it will not be possible to properly describe entrepreneurial action within a single behavioural pattern (nor in a single function or personality characteristic) [Stevenson (2006)]. Originally, Stevenson had suggested six dimensions to differentiate between managerial-entrepreneurial and managerial-administrative behaviour

respectively to discriminate between promoter and trustee roles, with the descriptions of these dimensions stemming from Stevenson (2006); the typical driving forces and sources for action of the entrepreneurial promoter and the trustee are depicted in Illustration 1-1

- Strategic orientation (driven by perception of opportunity vs. resources currently controlled)
- Commitment to opportunity (revolutionary vs. evolutionary)
- Commitment of resources (multi-staged vs. single-staged complete commitment)
- Control of resources (episodic use or rent vs. ownership or employment of necessary resources)
- Management structure (flat with informal networks vs. formalized hierarchy)
- Reward philosophy (value-driven and performance-based vs. security-driven and resource-based)

***Illustration 1-1:*** *Entrepreneurial promoter and the trustee*

| Pressures toward this side | Promoter | Key business dimension | Trustee | Pressures toward this side |
|---|---|---|---|---|
| • Diminishing opportunity streams<br>Rapidly changing:<br>• Technology<br>• Consumer Economics<br>• Social Values | Driven by perception of opportunity | **STRATEGIC ORIENTATION**<br>entrepreneurial domain<br>administrative domain | Driven by resources currently controlled | • Social contracts<br>• Performance measurement criteria<br>• Planning systems and cycle |
| • Action orientation<br>• Short decisions windows<br>• Risk management<br>• Limited decision constituencies | Revolutionary with short duration | **COMMITMENT TO OPPORTUNITY**<br>entrepreneurial domain<br>administrative domain | Evolutionary of long duration | • Acknowledgement of multiple constituencies<br>• Negotiation of strategy<br>• Risk reduction<br>• Management of fit |
| • Lack of predictable resource needs<br>• Lack of long-term control<br>• Social need for more opportunity per resource unit<br>• Interpersonal pressure for more efficient resource use | Multi-staged with minimal exposure at each stage | **COMMITMENT TO RESOURCES**<br>entrepreneurial domain<br>administrative domain | Single-staged with complete commitment upon decision | • Personal risk reduction<br>• Incentive compensation<br>• Managerial turnover<br>• Capital allocation systems<br>• Formal planning systems |
| • Increased resource specialization<br>• Long resource life compared to need<br>• Risk obsolescence<br>• Risk inherent in any new venture<br>• Inflexibility of permanent commitment to resources | Episodic use or rent of required resourced | **CONTROL OF RESOURCES**<br>entrepreneurial domain<br>administrative domain | Ownership or employment of required resources | • Power, status, and financial rewards<br>• Coordination<br>• Efficiency measures<br>• Inertia and cost of change<br>• Industry structures |
| • Coordination of key non-controlled resources<br>• Challenge to legitimacy of owner's control<br>• Employees' desire for independence | Flat with multiple informal networks | **MANAGEMENT STRUCTURE**<br>entrepreneurial domain<br>administrative domain | Formalized hierarchy | • Need for clearly defined authority and responsibility<br>• Organizational culture<br>• Reward systems<br>• Management theory |
| • Individual expectations<br>• Competition<br>• Increased perception of personal wealth creation possibility | Value-based<br>Team-based<br>Unlimited | **COMPENSATION/REWARD POLICY**<br>entrepreneurial domain<br>administrative domain | Resource-based<br>Driven by short-term data<br>Promotion<br>Limited amount | • Societal norms<br>• IRS regulations<br>• Impact information<br>• Search for simple solutions for complex problems<br>• Demands of public shareholders |

This taxonomy of entrepreneurial versus other forms of behaviour has been employed in a number of contexts, in particular in exploring differences between the behaviour of entrepreneurs and managers. Note also that the behavioural approach is useful for exploring entrepreneurial efforts in large, established organizations and is not limited to the start-up context. This is because in this approach, entrepreneurship is anchored in typical behavioural patterns of management rather than a specific institutional context of self-employment or business ownership [cf. Saßmannshausen (2009)]. Overall, the behavioural approach and its dimensions are not as prominent as the traits approach and its personality characteristics in the literature. However, the behavioural approach seems to hold substantial empirical validity as tested in a study by Brown, Davidsson, and Wiklund (2001). Thus, for studying entrepreneurship at the level of the individual business the behavioural approach may well hold more future potential than the traits approach which – as has been addressed above – has attracted substantial criticism in the past. In conclusion it should be noted that there are, of course, other definitional perspectives unveiling the specific features of the entrepreneur and the essence of entrepreneurial thinking. One example is the view of Fleischmann (2009), who has developed ten programmatic theses to describe what constitutes entrepreneurial thinking:.

Entrepreneurial thinking…

- …is *hopeful* thinking
- …is *melioristic* thinking – it wants to make or do something better
- …is *holistic* thinking – in the sense of connective thinking
- …is *action-oriented and team-oriented* – it has a multiplier effect
- *…embraces possibility and enables leadership*
- …is *emancipatory* thinking – and may be an antidote to alienation
- …is *social and ethical* thinking
- …is *creatively heuristic* thinking
- …is *utopian* thinking
- …is about *connective problem-solving*.

### 1.1.2 Entrepreneurship, Start-up and Growth

Although in economic science and business practice **entrepreneurship** is coming more-and-more to the fore, the term is still little-known in the European context. For example, in German-speaking countries, entrepreneurship only became important as a teaching and research field in universities at the end of the 1990s with the establishment of the first chairs and professorships dedicated to the subject. In some instances, entrepreneurship is also considered by the public to be a vogue expression which will lose its place value sooner or later.

The conceptual diversity of the term is also clearly recognizable by the broad spectrum of varying definitions and interpretations, as already shown above in the context of the historic development of the concept of entrepreneurship. [This diversity of definitions of entrepreneurship has also been noted in Shane/Venkataraman (2000) and Watson (2001).] However, the relationship between entrepreneurship and the concepts of entrepreneurial and growth management is also understood in different ways. Some, for instance, take the view that the terms entrepreneurship and enterprise formation are synonymous. Within this *narrow-concept interpretation*, entrepreneurship is restricted to the founding and start-up phase of an enterprise. In contrast to this extreme view, entrepreneurship is widely understood as referring to the complete life-cycle of an enterprise, i.e. to newly founded, young and established enterprises as well as to established enterprises involved in a crisis or in the process of reconstruction. In addition, entrepreneurship is also understood as a collective management concept within the meaning of an innovative approach of thinking and acting. As especially larger established enterprises often find themselves confronted with the problems of bureaucratic structures as well as insufficient internal innovation powers and development dynamism, entrepreneurship is also applied in this context. By developing an **entrepreneurial mindset** as an *entrepreneurial thinking and acting approach,* organization members are expected to achieve openness to change, a recognition and exploitation of business opportunities as well as an increase in value creation.

The demarcation between entrepreneurship and the areas of start-up and growth management continues to be blurred. Hans Jürgen Drumm and Michael Dowling, for instance, have already pointed out that the concepts of start-up management and entrepreneurship describe two associated problem areas which together comprise the emergence, formation, establishment and growth of young enterprises. Following this view, start-up management is to be understood in a narrower sense and entrepreneurship in a wider sense [Drumm/Dowling (2003)].

On the basis of a phase-related approach, the *organizational emergence phase (pre-founding) and start-up phase (at and immediately after founding)* form the centre of the **start-up management** perspective. Start-up management deals with the areas of entrepreneurial *creativity and opportunity discovery,* the potential *feasibility of the opportunity, i.e., evaluation and exploitation of an entrepreneurial opportunity,* the *business plan,* the *acquisition of required resources,* up to the concrete *formation of the enterprise.* In this context, the question arises whether the focal aspect of start-up management is concluded with the act of founding a business itself from the legal point of view (e.g., with the entry into the Companies Registry), and the growth management of young enterprises follows from the early development phase onwards. [For a discussion of "establishing a legal entity" as an indicator of business birth see, e.g., Carter et al. (1996).] In the entrepreneurship literature, a clear differentiation between start-up management and growth management is still lacking.

Newly founded enterprises and already existing young enterprises often have to cope with the same or similar problems and challenges. Even so, according to empirical studies, there are also typical problem sectors, which are different for each. **Growth management**, for example, focuses more strongly on *typical problem areas of leadership and organization of young growing* enterprises. The area of *growth strategies* is typically a subject of growth management. Irrespective of whether there is a fixed or fluid transition from the start-up to growth management of a young enterprise, it is important to recognize that the problem areas in the start-up and growth phases of a young enterprise often differ.

**Entrepreneurship** is generally characterized by *innovative, entrepreneurial thinking and acting processes* which are oriented towards the recognition and exploitation of business chances as well as to creating *economic value within a new enterprise*. Start-up management and growth management are understood as *core areas of entrepreneurship*. It is the aim of this book to describe essential aspects and problem areas of start-up *and* growth management in order to generate a fundamental understanding for the specific problems and challenges confronting newly founded enterprises and often rapidly growing young enterprises.

### 1.1.3 University Entrepreneurship

Entrepreneurial activities at institutions of higher education are significant to a region's or even a nation's economic development [Etzkowitz et al. (2000)]. This is because universities and other institutions may engage in technology transfer and produce high-growth start-ups in the area of knowledge-intensive and technology-based business which is crucial for future structural change and the emergence of novel industries [Yusuf (2007)]. A typical example of this is Stanford University in California which has contributed to the emergence of companies like Hewlett Packard, Sun Microsystems, and *Google*. The university has played a significant role in the development of the Silicon Valley and the rise of the modern microprocessor and information technology industry [Weiler (2003)]. For example, in 1996, more than 50% of all revenues of Silicon Valley businesses were generated by Stanford start-ups [Gibbons (2000); for an interesting study concerning the Cambridge high-technology cluster see Myint/Vyakarnam/New (2005)].

At the same time, there have been increasing demands on universities and other institutions of higher education to modernize their traditional roles in basic research and teaching, adding entrepreneurial activities to their set of tasks [Gibb (2005)]. And indeed it has been noted that universities have become more entrepreneurial over the last two to three decades, in particular in the United States but also elsewhere [Mowery et al. (2004); Rothaermel et al. (2007)]. Typical entrepreneurial tasks defining the entrepreneurial university are technology patenting and licensing, running start-up incubators or science parks, founding and supporting university start-ups, and acting as equity investors into new ventures [Siegel et al. (2006)]. Clearly, universities become entrepreneurial actors by generating licensing and other revenues, like business firms do as well as through founding spin-off companies based on technologies developed at universities. There may be several catalysts for this movement of universities to pursue such entrepreneurial activities [Rothaermel et al. (2007)]: increase in the number and professional mobility of scientists involved in technology development; novel basic technologies (e.g., in micro-processing, bio- and nanotechnology, or clean-tech); requirements to diversify university funding beyond state funding; and, in some countries, more favourable legal regimes providing incentives to universities to engage in technology licensing and venture creation efforts (e.g., the Bayh-Dole Act in the United States).

However, the challenges to build and sustain entrepreneurial universities seem to be quite different across developed economies around the world. North-American universities with their technology transfer and licensing offices have been criticized for focussing mainly on maximizing licensing income while somewhat neglecting entrepreneurial new venture creation. [Litan et al. (2007); see also Markman (2005) for reported tasks in the mission statements of technology transfer offices at US universities where venture creation only plays a subordinate role.] For Japan, it has been argued that entrepreneurial activity of universities is impeded by the lack of boundary-spanning institutions to liaise with industry (e.g., technology transfer offices or science parks) as well as expertise with regard to managing transfer processes. [Collins/Wakoh (2000)] With regard to European universities, Rothaermel et al. (2007, p. 2) suggest that "largely due to different legal systems, these universities lag behind in their efficiency of technology transfer compared to their US counterparts". However, the European Union has put forth policy initiatives to evaluate and improve both entrepreneurship education and technology transfer at European institutions of higher education [see, for example, European Commission (2008) and, earlier EIMS (1995)]. Important dimensions and target levels of entrepreneurial activity at universities are the individual university members (students and faculty), the university as an organization including its environment, and the infrastructure of academic start-up firms.

The intentions of university students to start their own business in the future have to be considered within the context of alternative career choices and often there will be substantial opportunity costs attached to the entrepreneurial career path [Wiklund et al. (2004)]. Important influencing factors for the formation of entrepreneurial intentions seem to be students' perceived desirability and feasibility of founding one's own business [see the works of Krueger and colleagues for the US case; e.g., Krueger/Brazeal (1994); Krueger, (2000)]. Recent studies investigating European university students indicate the relevance of social values concerning entrepreneurship for perceived desirability while feasibility judgements seem to be mainly driven by the level of perceived personal skills with regard to being an entrepreneur [e.g., Linan (2008)]. On the one hand, entrepreneurship as a career option seems to be attractive to students because of the social function of entrepreneurs; on the other hand, students' beliefs in their own personal skills and other feasibility factors like access to financing appear to be less positive [as indicated in Linan (2008), as well as in Guerrero et al. (2008) and Veciana et al. (2005)]. A study focussing on university students in Eastern European and other transition economies reveals that entrepreneurial potential is driven mostly by the present level of economic development rather than by country-specific factors like culture and degree of experience with market economies [Mueller/Goic (2005)]. Education policy efforts may therefore be targeted at improving the attitudes of students towards and image of entrepreneurship and, perhaps more importantly, at building their entrepreneurial skills and competences to strengthen confidence in their judgements of entrepreneurial feasibilities. Economic policy-makers in market economies can play a role in creating credible entrepreneurial opportunities in the eyes of students and graduates (e.g., by providing a relevant support infrastructure and improving general business conditions).

As far as other faculty members employed at universities are concerned, assistant and full professors may play important roles as supporters and promoters of new venture projects in their research institutes and lecturing activities [as indicated by a large-scale study of professors and lecturers at German universities; Isfan et al. (2005)]. With respect to their own entrepreneurial intentions as well as concerning supportive functions for student start-ups the study also indicates that university employees' previous personal experiences with self-employment as well as their knowledge about available support services at universities (e.g., consulting and coaching offers; funding programmes) may be critical.

In addition, such direct support efforts to stimulate entrepreneurial activity at the grass-root level may be complemented by transforming the university organization into an entrepreneurial university. There are five core elements characterizing this change [Clark (1998)]:

- a strengthened steering core at the university's top-management level and a clear organization-wide entrepreneurial mission;
- established boundary-spanning people and structures (e.g., technology transfer offices and business networks) to liaise with industry;
- commitment to a diversified funding base blending public and private sector sources;
- pursuit of a true multi-disciplinary approach and
- living an overall entrepreneurial culture embracing all university staff.

However, evolving towards an entrepreneurial university organization will not at all be an easy process. On one side, there is the hope of policy-makers that the entrepreneurial university will generate independent business income (thus offering some relief for tight public budgets) and will function as an engine of structural change and job creation in novel industries. [Garnsey (2007)] On the other side, the necessary cultural change at traditional universities constitutes a formidable obstacle which requires keeping a balance between public education and research mandates and private-sector commercial activities [Bok (2003)]. Internally, this also involves faculty members who may well fear a loss of scientific quality and independence as well as continuous and secure public funding [Lee (1996) and Van Looy et al. (2004)].

Overall, there may be a number of barriers with regard to the fostering of entrepreneurial change at universities:

- (potentially contrary) traditional objectives of universities and lacking visibility of and perceived support for entrepreneurial activity by faculty members [e.g., Feldman/Desrochers (2003)]
- insufficient knowledge of entrepreneurial management and available support infrastructure for new ventures [Isfan et al. (2005)]
- lack of incentives and perceived benefits of entrepreneurial activity at the individual level [Henrekson/Rosenberg (2001)]
- still insufficient prestige and public acceptance of entrepreneurial roles of university researchers and lecturers [Schmiemann/Durvy (2003)].

Such barriers may impede successful technology transfer and collaboration with businesses and organizations outside the university and may also hamper the formation and support of university spin-offs. These spin-offs, which pursue an entrepreneurial opportunity originated from but not exploited by the university, may involve the transfer of both technology and personnel from the university to the new venture [Steffensen et al. (2000); Nicolaou/Birley (2003)]. Typical industries in which such spin-offs (e.g., from Cambridge University in the United Kingdom) operate are information technology, biotech, and microelectronics. Specific factors which influence the establishment and growth of university spin-offs are related to the barriers and overall challenges to implement university entrepreneurship:

- University system and faculty [Franklin et al. (2001); O'Shea et al. (2005)]: attitudes towards academic entrepreneurs; incentive structures; support models; organizational experience with start-up processes;
- Founder characteristics [Clarysse/Moray (2004)]: personal experience with venture management; team homogeneity; social capital (particularly industry contacts and business networks);
- External conditions [Powers/McDougall (2005)]: industry R&D funding; existing market opportunities.

Principal approaches for promoting spin-offs from research universities in particular concentrate on identifying key success factors and maximizing the success of spin-offs (US focus); non-US institutions seem to focus more on removing the above barriers in order to stimulate the formation of spin-offs in the first place – namely information and competence deficits, resource scarcities, and cultural problems [Rothaermel et al. (2007)]. In sum, this leaves European universities and policy makers at the EU, national, and regional levels with ample room for tailor-made approaches to improve the entrepreneurial culture at Europe's institutions of higher education to complement their academic mission in teaching and research. [See Volkmann (2009) for recent developments and case examples of high-growth entrepreneurship in institutions of higher education.]

### 1.1.4 Intrapreneurship: Entrepreneurship in Established Corporations

To put it roughly, **corporate entrepreneurship** at the organizational level and **intrapreneurship** at the personal level define entrepreneurial activity and behaviour within the context of existing, well-established business corporations. [For a detailed classification of these concepts as well as more finance-driven corporate venturing activities, see Faisst (2002).] Organization-level corporate entrepreneurship is viewed as a demanding – and sometimes ambivalent – management concept. By some, it has even been called a possible oxymoron [Thornberry (2001)], since large corporations are often considered as bureaucratic rather than entrepreneurial. Also, there may be differences in the cognitions and behaviour between managers and entrepreneurs [Kuratko et al. (2004)] as well as in the extent of entrepreneurial initiative across corporate management levels [Hornsby et. al. (2008)]. Conversely, corporate entrepreneurship may be an essential ingredient of the revitalization and renewal of established but inert large companies [e.g., Morris et al. (2008) and, from a strategic management perspective, Stopford/Baden-Fuller (1994)]. [See Thornberry (2001) for examples of corporate entrepreneurship initiatives in large multi-national companies like Cadbury-Schweppes and Siemens where top-management has worked to transform what originally used to be a fairly conservative and staid organizational culture into a more risk-taking, flexible, fast, and opportunistic one.] Within the narrower focus of corporate-venturing as a means of making venture capital investments in new businesses developed by employees (internal) or outside management teams (external), European corporations traditionally pursue strategic goals like taking advantage of new windows of technology or leveraging existing customers and distribution channels [EU Commission (1999)].

The origin of the idea of internal entrepreneurship may be traced back to an old issue of "The Economist" in which Macrae put forth that "successful big corporations should devolve into becoming confederations of entrepreneurs" and Pinchot, building on this article, coined the term "intrapreneurship" [Macrae (1982); Pinchot (1985)]. The essence of intrapreneurship is Schumpeterian in so far as "the internal entrepreneur, like the external entrepreneur, enacts new opportunities and drives the development of new resource combinations or recombinations" [Burgelman (1984), p. 164], and thus pursues "creative or new solutions to challenges confronting the firm" [Antoncic/Hisrich (2000), p. 22]. Overall entrepreneurial activity within existing corporations follows people-driven, Schumpeterian innovation which is embedded in an organizational and managerial framework to stimulate and foster precisely this kind of entrepreneurial initiative by members of the organization.

Typical **dimensions of intrapreneurship** are [Antoncic/Hisrich (2001)]:

- *new business venturing* [new venture creation with different degrees of autonomy redefining the company's products, services, and markets; Zahra (1991)]

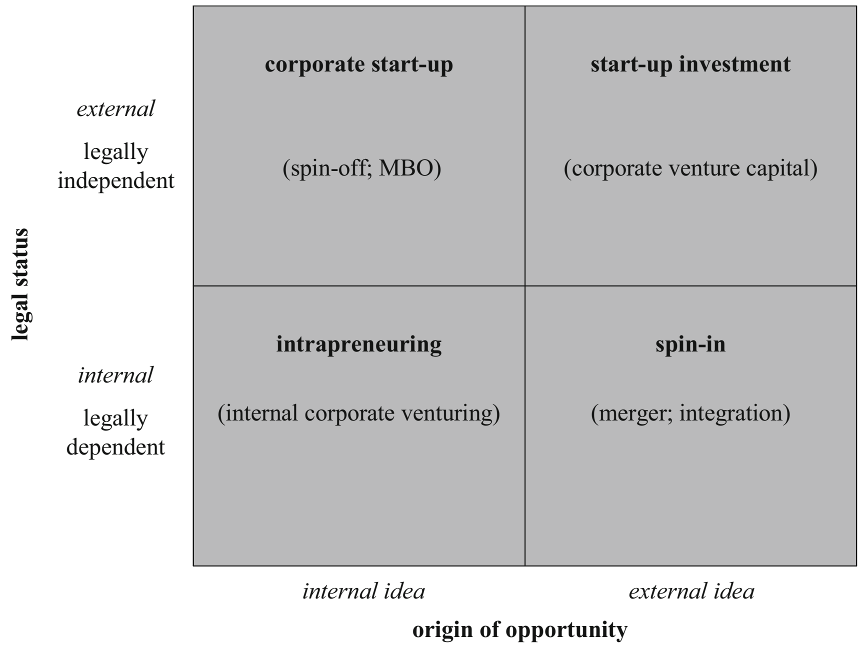
- *innovativeness* [product and service innovation within the organization, often utilizing and developing new technologies; Knight (1997)]
- *self-renewal* [organizational change and transformation of business concepts, structures and systems as well as overall strategic adaptability; Zahra (1993); Muzyka et al. (1995)] and
- *pro-activeness* [active posture relative to competitive rivalry; Knight (1997)].

Developing and sustaining organizational corporate entrepreneurship and intrapreneurship is a challenging task, essentially because it requires the utilization of firm resources and knowledge on a continuous basis [Zahra et al. (2008)]. In particular, it may be difficult for new entrepreneurial initiatives to win resource support and management commitment against the background of established, customary ways of doing things. Such barriers may be similar to those articulated for innovation management in general, requiring specific power, process, and relationship "promotors" to overcome them [Hauschildt/Kirchmann (2001)]. Such managerial promotors of innovation provide new business ideas with top-management protection and support, as well as foster new business development with their process-knowledge and social capital in the form of well-tuned intra- and extra-organizational networks (e.g., contacts with R&D people and possible technology partners). The management task of designing and maintaining adequate framework conditions for entrepreneurial activity within business organizations evolves alongside two principal issues:

- developing a suitable organizational form to initiate and host new venture projects and
- understanding the environmental and organizational preconditions for successful intrapreneurship.

**Typical forms of new business ventures in existing organizations** may be differentiated in terms of their legal status (external independent/internal dependent) and the origin of the business idea (internal opportunity/external opportunity) [see Illustration 1-2 adapted from Linz (2001)]:

*Illustration 1-2:* *Organizational forms of corporate entrepreneurial activity*




Management should opt for a specific form depending on the operational proximity between the company and the venture project and the strategic relevance of the project [Suessmuth-Dyckerhoff (1995); Burgelman (1984)]: legally independent forms like corporate venture capital and, in particular, spin-offs may be useful in case of only modest strategic relevance and operational closeness; internal venturing with its closer ties and more direct control and access (in terms of resources and know-how) may be preferable for projects with more pronounced operational linkages and strategic assets. With regard to the latter there may be different ways to organize this, for example: direct integration (maximum operational proximity and strategic importance); a new business department around the venture project; a micro new-venture department hosting different innovative venture projects with a considerable degree of independence from the rest of the organization (that is, with little proximity; often transforming into an external venture as a spin-off) [Suessmuth-Dyckerhoff (1995)]. There are different strategic objectives that may be associated with corporate venturing activities [cf. Linz (2001); EU Commission (1999)]:

- improving the company's know-how basis and exploiting emerging technological opportunities

- addressing new markets and customer needs
- pre-empting stagnation and decline in the growth of mature business units
- strengthening organizational learning and agility in general.

There may be numerous **environmental and organizational factors and conditions** which inhibit or catalyze intrapreneurial activity so as to meet the above objectives, e.g., dynamism and competitive rivalry within the environment and communication structures and formal controls within the organization. [A good overview is provided in Antoncic/Hisrich (2001).] In particular, for actively stimulating intrapreneurship within the organization, "communication openness, control mechanisms, environmental scanning intensity and management support, and organizational values" are considered as important predictors of intrapreneurship (ibid., 13). Overall, there may be various practices in human resource management for supporting innovation and corporate entrepreneurship in general. [See Hayton (2005) for a review of empirical evidence on the merits of both human resource management practices and systems.] Beyond direct material support and favourable management systems recent research has also shown that managers' emotional displays may motivate employees to act entrepreneurially, in particular when displaying satisfaction with and confidence in entrepreneurial projects rather than frustration and bewilderment [Brundin et al. (2008)].

In summation, senior and top-level managers face a three-fold task

- taking entrepreneurial initiative themselves
- implementing a conducive organizational support infrastructure and management system, and
- acting as role-models and leaders fuelling employees' motivation to adventure entrepreneurial projects.

One item may be added to this agenda for the specific case of intrapreneurship in Eastern European transition economies. In their case study of Slovenia, Antoncic and Hisrich (2000) found that while patterns of entrepreneurial activity within established corporations are only slightly lower compared to the United States, performance levels however lag behind quite substantially; i.e., there will be the additional challenge of generating higher levels of business performance from intrapreneurship and innovation initiatives in emerging market economies.

### 1.1.5 Characteristics of a Young Enterprise

It has proven difficult to arrive at dimensional classifications of growth-oriented entrepreneurial versus small businesses, imitative versus innovative start-ups, or young versus established enterprises because of the large variety of types of businesses across many industry sectors [Grünhagen (2008); see also Storey (1994); Curran/Blackburn (2001) and Fallgatter (2002)]. For example, Curran/Blackburn (2001) note that measurements of factors such as number of employees or financial turnover will tend to be sector-dependent.

Several attempts can be found in the small business and entrepreneurship literature that try to establish a definition in this context using qualitative economic themes like uncertainty, innovation, evolution, market share, owner-management, and independence for the (statistical) definition of, e.g., small, and, at the beginning, new enterprises [Wynarczyk et al. (1993); Storey (1994); Curran/Blackburn (2001)]. It has to be noted that a universal definition or description of growth-oriented entrepreneurial versus small businesses, imitative versus innovative start-ups, or young versus established enterprises may not be appropriate because such a description may not be precise. However, for a general understanding a brief overview of possible arguments to differentiate between young and established enterprises is presented below. In this context variables like firm age and break-even-points will be discussed. Having said this, firm size is not an adequate variable in this context.

Venture age may well be the most important differentiating factor between young ventures and established ventures. In particular, problems of resource access and legitimization facing young ventures that may differ from those of older, more established entities play a role here [cf., for example, Aldrich (1999) or Tornikoski (2005)]. In the German literature enterprises up to 20 years old are sometimes designated as young, growth enterprises [Knips (2000)]. According to Timmons, the start-up and growth period comprises a total time span of ten years maximum when based on a life-cycle model [Timmons/Spinelli (2004)]. Accordingly, an age of up to ten years may be assumed for demarcating young enterprises. However, there are many alternative approaches to defining a young enterprise. The difficulty of defining the time-framework is due to the heterogeneity of firm development sequences [Delmar/Shane (2004a)] and substantial sectoral differences. [Fallgatter (2002); for example, the successful market establishment of a services start-up may take much less time than the establishment of a biotechnology enterprise.] These alternatives are also reflected in definitions of young enterprises. For example, the *Kreditanstalt für Wiederaufbau*, (Germany's state bank involved in enterprise policy), defines *young technology enterprises* as companies which are no older than five years, and which satisfy the criteria of the EU commission for small enterprises. [For the demarcation of young enterprises according to EU criteria, see the explanations in the present chapter.] For example, a sensible threshold for an enterprise to still qualify as "young" may therefore be an age below three years. This time period is a cautious choice as the relevant literature assumes firms to be young up to the age of three to five or even up to seven years [for an overview see Tornikoski (2005); also cf. Fallgatter (2002)].

When only a specific period of time in the firm development process is concentrated on (for example the infancy stage of young ventures), a temporal differentiation will be needed. However, sketching out a time frame between emerging, but not yet existing organizations, and established mature organizations is difficult because of the indeterminacy of the firm organizing process.

> *"Firm founders do not instantaneously establish new firms, but create them through a series of actions – obtaining inputs, conducting product development, hiring employees, seeking funds, and gathering information from customers – undertaken to different degrees, in different orders, and at different points in time, by different firm founders." [Delmar/Shane (2004a); also cf. Carter et al. (1996)]*

This observation shows that there is no clear picture for defining a young venture in contrast to an emerging or an established venture. This is not only due to the heterogeneity of development sequences but – as addressed above – also because of sectoral differences [Fallgatter (2002)]. Consequently, a prudent maximum age threshold for young enterprises in combination with qualitative criteria relating to the analytical domain under study would seem the most sensible approach to take.

As a core definition young ventures

- are not older than three years
- have not yet gained a stage where they have reached their break-even point and
- sustainability from internal cash flows (cash-flow positive and break-even reached).

Not yet being cash-flow positive and still being in the loss area is argued to be a sign of youth and lack of settled establishment of a new firm. In this context Brachtendorf (2004) argues that firms are young until financial sustainability from internal operational cash flows is achieved. This definitional differentiation is followed here.

All in all, the listed examples show that the designation of *young enterprises* can be taken as a relative quantity. To commit oneself to a specific definition is therefore not without problems, although an unequivocal and standard concept interpretation would only be desirable with regard to entrepreneurship research and teaching.

Empirically, one of the most striking differences between young and established enterprises is the higher mortality rate of the former. Gruber and Henkel (2004) remark that, depending on industry sector, up to as much as 70% of new firms do not survive the first five years. Firm age as a predicting variable of organizational mortality has been explored in numerous studies, in particular those that analyse cohorts of new firm populations from an organizational ecology perspective [for an overview see, for example, Hager/Galaskiewicz/Larson (2004), or, for earlier contributions, Levinthal (1991)]. Hager/Galaskiewicz/Larson (2004), however, also remark that more recent studies have also explored additional factors of organizational mortality beyond the age variable alone.

**Liability of newness, smallness and adolescence**
The above-mentioned difficulties of quantitative definitions have led to more qualitative approaches [also see Curran/Blackburn, 2001 for the same definition strategy with regard to small businesses]. In the scientific literature, young enterprises are generally characterized with the help of specific qualitative features. Primary possible features of young enterprises are the *newness degree of the enterprise* (liability of newness), the small *size of the enterprise* (liability of smallness) as well as the *dynamism of the enterprise.* The **liability of newness** means a high probability that the enterprise will fail because the organization with its structures and processes is not yet finished and is still involved in the building-up process. [For the original concept, see Stinchcombe (1965); for typical internal and external liabilities of newness like lacking organizational routines and established exchange ties with stakeholders, see Henderson (1999) and Gruber (2003) and Table 1-2 below.] In this phase, mistakes are made, as no experiences are yet available to fall back on. At the same time, it has not been possible to build up long relationships with customers and suppliers or other stakeholders of an enterprise. The **liability of smallness** goes hand-in-hand with a shortage of resources, mainly of personnel and finances [Brush (2001)]. Young enterprises often have resource structures which are open to the exploitation of entrepreneurial opportunities but require readjustment throughout the exploitation process. Due to the lack of reputation and planning information, it is difficult for young enterprises to acquire tailor-made financial and human capital resources. [See Stevenson/Gumpert (1985) who remarked some time ago that entrepreneurial start-ups will lack predictability for initial resource planning because of the dynamism of the enterprise itself as well as its environment.] Given the *dynamism of the enterprise*, a young enterprise is in a strong and sometimes very fast and continuous process of change. The change can be initiated both by internal as well as external factors of influence [Brüderl/Preisendörfer/Ziegler (1998); Fritsch et al. (2004); Gruber (2004); Hager/Galaskiewicz/Larson (2004)].

**Liability of adolescence** provides an important differentiation to the liability of newness notion. The liability of newness argues that failure rates of new organizations decline monotonically over time since newness problems are most severe at the time of founding and decrease thereafter. In contrast, the liability of adolescence concept combines empirical observations that "the risk of death for an individual organization is initially quite low and increases with time, reaching a peak at a point referred to as adolescence, and then subsequently declines" [Levinthal (1991), p. 401; similar results have been reported by Bruederl/Schuessler (1990) and Jungbauer-Gans (1994); see Grünhagen (2008)]. The explanation for this delayed mortality risk is assumed to be that, at the beginning, new organizations "are bolstered by initial stocks of resources and reserved judgement from supporters and decision makers that allow for a 'honeymoon period'. Once the stock of resources is depleted, however, risk of demise increases" [Hager/Galaskiewicz/Larson (2004), p. 184.] For the individual new firm, the compelling argument explaining its survival immediately after founding is that "not only are firms typically founded with some stock of financial capital but, often, with many other sorts of assets" [Levinthal (1991), p. 400]. The idea here is that new ventures survive in the beginning because entrepreneurial projects are turned into new organizations only when resources are in place to make sure that the firm has a fair try towards achieving market entry and will not go bankrupt on its first day of business. In many cases this will mainly involve liquidity provided by the founder's personal savings [cf. Aldrich (1999)].

Table 1-2 gives a survey of the classification of the liability of newness, smallness and adolescence [Grünhagen (2008)]. Note that there will be both problems within the young enterprise and outside the organization with its relationships to externals.

***Table 1-2:*** *Characteristic liabilities of new venture organizations*

| Liability form | Internal problem area | External problem area |
|---|---|---|
| liability of newness | lack of established organizational structure adequate to external market characteristics; scarcity of management time and resources to implement organizational role duties and competences; initial costs of defining and implementing intra-organizational roles and processes | underdeveloped exchange relationships and dependence on social interaction with strangers; lack of access experience and reputation to initiate new relationships; generally unknown organizational entity to external parties; lack of proof of business concept; lack of trust in firm abilities and offerings; lack of reputation of entrepreneur as a professional |
| liability of adolescence | problems to implement full scale business operations; continuing problems to implement viable and efficient organizational roles and processes; lack of financial funds to follow through with organizational establishment | lack of sustained acceptance of planned full scale business concept; problems with second-round resource acquisition due to persistent uncertainty about long-term viability of business conception |
| liability of smallness | vulnerability to unfavourable market conditions due to resource poorness; difficulties to adapt market entry and business strategy because of limited financial flexibility; competence gaps through low specialization of labour because of lack of human resources | reliance on attracting external resources in critical situations |

While the above liabilities may hamper survival and growth it is, however, to be taken into account that **not every enterprise grows**, for young enterprises often remain small [Aldrich (1999)]. This can occur for **organizational or external reasons,** such as the *type and degree of innovation of the business model* or the type and age of the business sector.

Founders also often decide *consciously* against growth. [See Davidson (1991) for the role of founders' and business owners' growth aspirations in fostering or hindering small business growth.] In this case, no potential internal or external problems are prominent which might hinder growth. It is simply that no growth is desired, possibly because the founders would like to keep control over the complexity of the enterprise.

High rates of growth tend to be found more often in new lines of business. This is confirmed by an empirical study of the Centre for European Economic Research (ZEW) concerning high-technology start-ups in Germany. Data was generated on the basis of telephone interviews with 1,002 enterprises, which had been founded between 1996 and 2005, from a random sample of 8,000 enterprises of the ZEW start-up panel. The average employment growth per year within the framework of the study period lay at 37 percent of the interviewed high-tech enterprises. In the software sector the growth rate was 44 percent. The ZEW study arrived, however, at the result that the rate of new business formation in the technology-intensive economic segments of the manufacturing industry as a total was on the decrease. The ZEW identified as success factors of the high-tech enterprises the acquisition of financing, the orientation of the product to its usefulness for customers as well as a market-oriented further development or general new development of products. According to this study, a main impediment for growth is a lack of qualified personnel [Niefert/Metzger/Heger/Licht (2006)]. As success and failure are complex and depend on many variables, the research of success factors does not remain undisputed [see, e.g., Fallgatter (2005)]. Nevertheless, this research can assist in gaining in-depth knowledge, for instance, in the area of young enterprise growth.

Young enterprises can be classified systematically as small and medium enterprises. Various specific characteristics distinguish small and medium enterprises (SMEs) from large-scale enterprises. However, until now there has been no standard definition of the term SME. A demarcation of SME can be made using (*uni-dimensiona*l) qualitative or quantitative criteria or a combination of quantitative and qualitative (*bi-dimensional*) criteria. [See Curran/Blackburn (2001) for typical quantitative, qualitative and mixed definition approaches.] A **quantitative demarcation** represents a pragmatic procedure which uses *statistical* quantities, on a spectrum of potential definition characteristics that range from *number of employees* via *annual turnover, balance-sheet total, gross value creation* to *fixed assets.* The convenient *empirical measurability* is an essential advantage of quantitative demarcation criteria. In contrast, a **qualitative demarcation** of the SME against large-scale enterprises is often made by means of classical distinguishing features. These are features such as the *influence of the personality of the entrepreneur* (property, leadership, responsibility and risk are in one hand), *informal and close contact between management and staff of enterprise, low degree of formalization of the organization, flat hierarchies* etc. The use of qualitative characteristics facilitates a detailed identification of SMEs. An important disadvantage is, however, that in individual cases the characteristics, which are typical for the SME, can also be applicable to large-scale enterprises and vice-versa impeding a clear demarcation.

One definition, which is fundamental and predominant within the European Union, is based on a recommendation of the European Commission of 1996 and updated in 2003 (recommendation 2003/361/EU). This definition formulated in 2003 has been valid since the beginning of 2005, replacing the 1996 definition. By it, SMEs are classified into three **enterprise size classes,** *smallest, small* and *medium enterprises* based on the criteria: *number of employees, annual turnover* and *annual balance-sheet total.*

Table 1-3 gives a survey of the classification of enterprise sizes. [European Commission (2003)]

***Table 1-3:*** *Classes of enterprise size*

| Enterprise size | Number of employees | Turnover in €/year | Balance-sheet total in €/year |
|---|---|---|---|
| ■ Smallest enterprises | < 10 | Up to 2 million | Up to 2 million |
| ■ Small enterprises | < 50 | Up to 10 million | Up to 10 million |
| ■ Medium enterprises | < 250 | Up to 50 million | Up to 43 million |

The definition of the complete SME group of smallest, small and medium enterprises therefore comprises enterprises with a number of up to 249 employees *and* an annual turnover of up to 50 million Euros *or* an annual balance-sheet total of up to 43 million Euros. In each case, the number of employees and the turnover or the balance-sheet total of the enterprises decides the classification. In accordance with the governing law, three different enterprise types, *independent enterprises, partnership enterprises* as well as *affiliated enterprises* are to be taken into account when calculating the number of employees and the financial threshold values. [See also in particular the statements of the EU Commission (2003)] By means of a standard EU definition of SMEs, the European Commission wants to prevent diverging interpretations of enterprise size with regard to joint programmes of the EU (sponsoring programmes) as well as possible competitive distortions.

Within the group of small and medium sized enterprises, new and young enterprises show special characteristics and have therefore to meet specific challenges (constitutive decision problems, such as choice of location and legal form are of fundamental importance for a new enterprise, for example). Selected characteristics defining young enterprises as compared with established large-scale enterprises will be discussed briefly in the following sections.

**Availability of Resources**
*Young enterprises* are commonly faced with the problem of *shortness of resources* and need to build a resource base in the first place [Brush (2001)]. With this background, the *decisions of the entrepreneur* herself/himself have an immediate *influence on the survival chances of the enterprise.* Within this context, a sound *business plan* written by the founders themselves is of crucial importance, in particular for acquiring external financial resources. The business plan contains the "vision" and plan of the founders with regard to the establishment, development and growth of their enterprise [Delmar/Shane (2004b)]. The aspects which are relevant for the successful realization of the start-up project are documented in the business plan as comprehensively as possible.

In contrast to young enterprises, the conditions of business for *established large-scale enterprises* are different. On the one hand, there is, as a rule, an *existing extended resource base* in the various areas of the enterprise thanks to the longer life of the enterprise and a track record of successful previous entrepreneurial activities. The activities contained in the business plan have already been put into practice in a sustainable way and been transformed into operational and strategic *business planning*, and the strategic orientation of the enterprise is shaped by competent and responsible management.

**Marketing and Innovation**
In many cases, y*oung enterprises do not* have their *own marketing departments.* The assumable personal and financial shortness of resources hinders the employment of many classical marketing devices which are proposed for large-scale enterprises in the relevant literature, such as TV-spots or large format print-advertisements. It is true to say that this shortage of resources in young enterprises also leads to a search for intelligent solutions via targeted marketing. Rather than following standard marketing procedures of marketing departments in large enterprises, the founders pre-set the strategic marketing orientation as well as the individual associated marketing tools. In this context, the "*self-marketing" of the founder-person* and being able to communicate a convincing entrepreneurial story of the commercial prospects of the new enterprise is of crucial importance [cf. Aldrich (1999); Loansbury/Glynn (2001); Nicholson/Anderson (2005)]. There are numerous entrepreneurial personalities who are well-known for their self-marketing, amongst them, for instance, Richard Branson (Virgin) and Steve Jobs (Apple Computer). In some cases, the name of the founder is also built-up and established as a trade-mark such as Claus Hipp (Hipp baby food), Werner Otto (Otto mail-order business) or Bassier, Bergmann & Kindler (media agency). In order to compensate for the low resource equipment, the founders often enter *marketing co-operations.* In doing so they have the chance of overcoming the shortness of resources but are also faced with the risk of entering into dependences. Moreover there is the danger that the marketing strategies of the cooperating partners do not conform to their own strategies.

In *established enterprises,* on the other hand, there is usually a *specialization of functions* through marketing departments. Marketing is consequently carried out by an independent sector of the enterprise. An increased personnel and financial resource equipment facilitates the employment of diverse marketing devices. However, inefficiencies can also develop in marketing departments, if, for instance, creativity is restricted by rigid structures. Established enterprises often have entered selected target-orientated marketing co-operations, which, however, seldom end in dependences, as the enterprises possess sufficient resources for carrying out independent marketing strategies.

In literature, *young enterprises* are often assumed to be *especially innovative.* This means that there is a degree of novelty in their business concept, products or services, which will allow them to be successful in competing with established enterprises and their products. This innovative aspect is therefore a necessary although not sufficient condition for successful market entry and establishment. In young enterprises, the innovation capability is encouraged, not only through its *flat hierarchy* and the associated *direct contact* between the founder or the founder team and the potential staff [Gruber (2003)], but also through a *high intrinsic motivation of the organization members* and a *simple, clear organization structure.* Very often, newly founded enterprises offer only one product. In these cases, typical challenges for young entrepreneurs are high development costs as well as long development times for new products and a linked *high capital demand* (e.g., in the case of biotechnology start-ups). Self-owned large research and development departments are capital-intensive and rarely found in young enterprises. *Research co-operations* are one possibility of counteracting possible resource shortages such as low capital equipment [cf. Alvarez/Barney (2001)]. For this purpose, an *absorptive capacity* of the young enterprise is required. The concept of absorptive capacity as formulated by Cohen/Levinthal (1990) refers to the capability of an organization to absorb or take up information resources from the outside and to convert and exploit them internally in the organization. This concept also refers to the increase of organizational capacities of knowledge processing through internal diversification of knowledge. According to Cohen/Levinthal (1990), an enterprise can only exploit those external information and knowledge resources which can complement existing knowledge within the organization. For young enterprises, this also means that a certain degree of own, compatible knowledge is required as a crystallization point in order to exploit external knowledge effectively. Many *established enterprises* do not carry out any innovation activity, but exclusively market their existing products without generating in-time successor products. In this way, established small and medium sized enterprises in particular get into a crisis. In established organizations, *existing organization structures* often become problematic, as they do not encourage (and even directly or indirectly hinder) creative development of their staff. At the same time, it is exactly the disregard of improvement and product proposals from organization members, which impede motivation and sometimes also damage the innovation climate and working atmosphere across the whole organization. Quite often, the management of established enterprises cannot or does not want to realize the ideas of employees. Very often there is a lack of time or personnel resources for putting an idea into practice. In large-scale enterprises this situation often produces chances for entrepreneurial spin-offs from the established enterprise through individual staff members.

**Organization and Personnel**

In *young and fairly small enterprises flat hierarchies* and *short decision routes* can be assumed in the organization of the enterprise [Wilkinson (1999)]. There is often a *low degree of formalization* and *organizational tools are* rarely used. Often organization members act on their own initiative. Due to the *low division of labour* within the enterprise caused by limited personnel resources, *a high degree of flexibility* is required from the acting persons. Many organizational processes can, however, be *concentrated on the founder* in the final analysis. The founder as a leader is of high importance in the early stages of the enterprise development, as in the majority of cases there are no employed managers in the enterprise. Her/his social, technical and methodical competences for leading the employees, for planning and organizing are essential for the success of the enterprise. Growth, which can be fast and dynamic, often involves organizational change of the enterprise which has to be dealt with. The enterprise must adjust its organization flexibly to changing or even entirely new conditions.

As opposed to young enterprises, *hierarchical structures* as well as an *increased degree of formalization a*re found in larger *established enterprises,* assuming a functionalized or specialized role of the staff members. Due to a higher division of labour, *specialization advantages* can be achieved. In established large-scale enterprises, the *management usually acts in dependent employment,* whilst the concentration on the original founder(s) is gradually decreasing. In many cases, the founders have withdrawn from the enterprise or have possibly been pushed out. One example was the (initial) retirement of Steve Jobs from the enterprise *Apple Computer,* which he founded in 1985. This situation can, however, also be used by the new management as a chance for renewal. It is possible that with his new enterprise, a retiring founder will develop into a competitor. Steve Jobs, for example, after having retired from Apple, founded the enterprise *NeXT Computer* as well as the animation studio *Pixar*, which was sold in 2006 to Walt Disney. Although some innovative soft- and hardware technologies were developed and converted into products at NeXT, the developed hard- and software has not really been successful, except in the field of research. However, in 1996 Apple bought the enterprise because of its operating system NeXTStep. The software developed in NeXT, which is part of this operating system, forms the basis of the present Apple operating system Mac OS X. In the same way, Apple did not only buy NeXT and its technologies, but also hired Steve Jobs himself, who in 1997 became a member of the Board of Directors in Apple Computer and later also Chief Executive Officer (CEO).

**Financing**

There are also special requirements or characteristics of *young enterprises* in the area of financing. For young enterprises with substantial growth ambitions we can commonly assume a *high demand for equity capital* [Gompers/Lerner (2003)]. In the first few years, young enterprises often have to accept losses, so that internal *self-financing from profits* can rarely be considered. Due to the degree of newness of young enterprises as well as to the limited existing resources, there are in many cases few or *no typical assets which may be pledged as collateral according to established banking practice* [Shane (2003)]. This means that the *access to outside debt capital* is difficult, as credit institutions demand that loans are collateralized. Moreover, in the majority of cases young enterprises do not yet have a *credit history* and a business relation with a bank on which lending could be based [Berger/Udell (2003)]. Collateral securities and a positive credit history must be built up in the course of time. Because of limited scope for internal financing and external debt financing young enterprises will have to rely on external equity financing [Denis (2004)]. It is particularly important that in addition to the operational entrepreneurial risks, the business model may still be new and not yet tested, so that there are additional market and strategic risks with regard to the permanence and success of the enterprise [Fiet (1995)].

As regards *established, large enterprises*, on the other hand, it can in many cases be assumed that those enterprises have plenty of scope for internal financing, for example, through retained earnings and continuous cash flows. In terms of collateral, thus an *extended range of securities according to established banking practice* should be available based on an existing asset base and established business activity. A positive credit history and an established relation with the bank have probably been built up over many years. In this case the permanence, evaluation and future success of the business model can be estimated much more easily, as the enterprise has already been on the market over a longer period. These differences to young enterprises make it usually possible for established enterprises to find better access to outside equity and debt capital.

**Growth Strategies**

It is first of all typical for *young enterprises to concentrate on operational entrepreneurial activities, i.e., simply "doing business".* The founders are normally involved in the daily business without having the possibility of delegating tasks to employees. This typical situation is mainly due to the shortage of resources in young enterprises. Strategic decisions, for example, with regard to the growth of the enterprise, are neglected because of the demands on the time of the founders involved in the daily business.

There are, however, also individual newly founded enterprises which consciously follow a particular growth strategy. Growth can occur in different ways or through a variety of strategies. The spectrum of growth types and strategies ranges from *internal growth, e.g., as technology- or customer-oriented strategies,* via *external growth* in the form of *enterprise takeovers,* to *cooperative growth*, for instance, in the form of *strategic alliances, joint ventures or franchising,* or *growth strategies with the employment of collaborative technologies.* At the same time, growth strategies can refer to products and/or markets. The type of growth or form of growth strategy that is chosen by a young enterprise is an individual decision of the founders in question. As a rule, the *growth strategies* or decisions *are moulded by the founders* [cf. Lafuente/Salas (1989)].

In principle, the same growth strategies are available to young as well as established enterprises. However, in contrast to young enterprises, in the latter case, *growth strategies* and decisions are usually *developed and implemented by employed managers.* Thanks to a stronger division of labour, the management is often able to focus better on strategic tasks and the development of growth strategies than entrepreneurs and owner-managers in young and small businesses do.

**Young Enterprises versus Established Enterprises**
Specific advantages and disadvantages of young enterprises can be deduced by demarcating the characteristics of young versus established large enterprises.

Table 1-4 gives a survey of advantages and disadvantages typically attributed to young enterprises.

*Table 1-4: Relative advantages and disadvantages of young enterprises*

| Criterion | Advantages | Disadvantages |
|---|---|---|
| **Founders/ management** | – High commitment of founders/management<br>– Fast decision making<br>– Recognition and exploitation of entrepreneurial opportunities | – No or limited reserves of management capacity<br>– Frequent concentration of all decisions on the founders |
| **Organization** | – Little bureaucracy due to flat hierarchy | – Sometimes no specialized sectors/departments |
| **Communication** | – Short and direct routes of communication | – Often complicated collection of external information |
| **Personnel** | – Motivated staff<br>– Diverse range of tasks and responsibilities | – Strong dependence on founders<br>– Restricted chances for advancement |
| **Market and marketing** | – Direct customer orientation<br>– Flexibility<br>– Adaptation to customer needs | – Low exploitation of market and product synergies<br>– Weak market force |
| **Innovation/research and development** | – Research and development efficiency<br>– Adoption of innovation competence through tacit knowledge | – Rarely any economies of scale<br>– Rarely any economies of scope<br>– Low risk diversification<br>– Discontinuous activities lead to know-how losses |
| **Financing** | – In fast growing enterprises usually high capital requirement | – Typical difficulties in acquiring financial resources and generating cash flow |
| **Strategy** | – High strategic and operational flexibility | – Medium- and long-term planning may be neglected due to operational problems and obligations regarding daily business operations |

Note, however, that some disadvantages listed in Table 1-4, which refer to lacking opportunities for obtaining resources or lacking *economies of scale* (size-cost economies, scale effects and scale returns) and *economies of scope* (vertical integration effects or resulting synergy effects), can often be compensated by the use of strategic cooperation partners or a suitable network.

### 1.1.6 Forms of New Enterprise Formation

Depending on the approach, thoroughness and orientation taken, a great variety of types can be identified for the systematization of forms and paths of new enterprise formation. An example would be the systematization according to the motive for founding the business, such as *opportunity entrepreneurship* (chance) or *necessity entrepreneurship* (need). Other forms of classification can be made according to the target, as *profit-oriented start-up (for-profit venture)* or as *socially-oriented (non-profit-venture).* The following representation is based on a fairly simple classification as discussed in the relevant literature on *innovative* and *imitative new enterprises* as well as on *original* and *derivative formation of new enterprises* (and mixed forms in-between) [Luger/Koo (2005)].

#### 1.1.6.1 Innovative and Imitative New Enterprise Formation

**Innovative new ventures or enterprises** are based on a *new business idea*, which has not yet been introduced and tested on the market. [For a discussion of the differences between innovative new enterprises and imitative reproducers and the implications of these differences in terms of market strategy see Aldrich/Martinez (2003).] This idea is associated with a *high degree of newness of products and services* and thereby usually with a *high degree of uncertainty and corresponding requirements for legitimizing and explaining the business and its product offers with regard to external stakeholders* [Aldrich/Fiol (1994)]. However, it is advantageous that the new enterprise is often confronted with less competition in its specific market because of the newness of its product offers. Another advantage is that innovative new ventures have, as a rule, a lower risk of being imitated, often because products and services are secured by patents or other forms of protection. Yet, a disadvantage lies in the high degree of uncertainty as regards the success of the enterprise, one reason being that there are no experience values with regard to the practicability of the business idea and the market acceptance of the enterprise's products and services. Under these circumstances, it may also be difficult to determine adequate sales prices due to the lack of market experience. Innovative enterprises are often founded in the area of technology, e.g., in biotechnology or in the IT industry. Innovative ventures need not, however, be based on finance-intensive research and development activities (examples of which include the banking and personal-finance sector).

**Imitative new enterprises**, on the contrary, are based on an already *existing business idea*, or a business idea which has already been introduced and tested in the market. The products or services of these enterprises are already known in the market. The *need for explanations of the products* is usually *low*, as the customer is already familiar with the products and services [Aldrich/Martinez (2003)]. Examples of imitative enterprises are traditional artisan businesses such as the businesses of carpenters, hairdressers, electricians or roofers. However, these can also be service enterprises such as multimedia agencies or mobile care services. The spectrum of the business sectors is wide and diverse, ranging from new venture formation in the catering industry through the retail to the media industry sectors. The *imitation degree is high*, and the business idea is usually easy to copy. The acceptance of the existing products on the market may be seen as an advantage. The pricing is also simplified, as there are already existing observable market prices. Moreover, market data and experience values are available, which in most cases can be used for assessing the prospects of success and risks. The often intensive competition, together with saturation tendencies, is, however, problematic. In the sector of imitative businesses, certain further categories can be sub-summarized which are built on an already existing business idea, product or service. These are, for instance, paths for possible product differentiation (varying the features of a product), where existing products are given improved functions.

When differentiating newly founded enterprises as imitative or innovative, the question often arises, when a product or service can be seen as innovative [cf. Schwarz/Grieshuber (2003)]. This question illustrates that a demarcation between innovative and imitative ventures cannot always be definite. An example: New enterprises based on further technical and other developments cannot always be classified as imitative, for there are always further developments which could be qualified as innovative. Moreover, statistics concerning innovative businesses should be looked at critically. In Europe, for example, the share of innovative new enterprises is assumed to be between one and five percent, in other words, between 95 percent and 99 percent of all start-ups are imitative (new) business formations [De (2005)]. In this context, the fundamental question arises: How can the number of innovative ventures be collected? From the point of view of an enterprise any new business founded can be considered to be new, as it leads to a new enterprise which so far has not existed in *exactly* the same form, i.e., with regard to the available resources. [A similar extended perspective on innovation is taken in Fallgatter (2002).] In spite of all existing practical demarcation problems, however, the classification into innovative and imitative offers a starting point for the systematization and in-depth characterization of new enterprise formation.

#### 1.1.6.2 Original or Derivative New Business Formation and Mixed Forms

In the relevant literature, a rather large number of classifications can be found for different forms of new enterprise formation. The following statements are based on the systematization approaches of Szyperski/Nathusius (1977), Unterkofler (1989) and Saßmannshausen (2001). According to these authors, a systematization of new enterprises is possible, based on the following dimensions: *individual business formation* and *co-operations* as well as *original business formation, derivative formation* and *mixed forms*. The dimensions of **individual business formation** and **co-operations** indicate "*who*" is responsible for the founding process. As potential initiators, *"founder persons"* and/or *existing enterprises* can be identified. Depending on the number of possible founders or enterprises, we have individual business formation or co-operations (team-founding). This co-operation can take place between individual persons, between persons/enterprises or enterprises/enterprises. Three further dimensions are *original, derivative* as well as *mixed forms of new business formation.* These dimensions illustrate *"how"* the founding process was carried out. *"Original" new enterprises* designate the *new build-up of factor combinations* in the form of capital and labour, for example [cf. Curran/Blackburn (2001) and Zimmerman/Zeitz (2002).] In this instance, a completely new enterprise is founded, built up and developed. So-called *"derivative" new businesses* are derived from the *takeover of already existing factor combinations.* Finally, there are forms which cannot be assigned to the pure original or derivative group or contain components of both forms (*mixed forms*).

It is possible that in this context the problem arises that forms of new businesses which are categorized as derivative, e.g., acquisitions, mergers or business takeovers are often not seen as truly new enterprises in practice. For the understanding of derivative new businesses, the *point of view* of the observer is decisive. From the perspective of a founder or founder team, a business-takeover or a management buyout represents a derivative business formation. Yet, within the framework of the presented systematization it is not possible to assign franchising clearly to original or derivative forms. This form of founding a new business therefore belongs to the mixed form.

Illustration 1-3 shows a survey of a possible systematization of new enterprise formation [following Saßmannshausen (2001)]

***Illustration 1-3:*** *Systematization of new business formation*

| | ***original new business formation***<br>build-up of factor combinations | ***mixed forms*** | ***derivative new business formation***<br>takeover of factor combinations |
|---|---|---|---|
| ***individual new businesses*** | individual start-up | | business takeover/succession (single) |
| | subsidiary start-up | | mbo/mbi (single) |
| | business start-up | | acquisition, merger |
| ***co-operative forms of new business formation*** | team start-up | franchising | business takeover /succession (team) |
| | joint venture | | mbo/mbi (team) |
| | spin-off | | split-off |

**Original New Business Formation**

**Individual start-ups** are founded by a *single* founder. Diverse advantages and disadvantages are connected with this form of starting a new business. It is advantageous that decisions have not to be discussed or agreed upon with other people in the enterprise, so that (in principle) decisions can be quickly implemented. Single start-ups do not require contractual arrangements or agreements between individuals or with regard to any possible claims, stakes in the enterprise, business management and representatives. These advantages are opposed by diverse disadvantages. The exclusive concentration of decisions on the founder is, for instance, linked to specific risks, as it may put a heavy stress on the founder person. Any long absence of the founder, e.g., through illness, can in an extreme case even threaten the existence of the enterprise. In addition, team founders may benefit from a broader set of skills and competences than a single founder (see below).

In the case of a **subsidiary** or **business start-up** the enterprise is built up as a branch or subsidiary of an existing enterprise. The purpose of the newly founded enterprise depends on the targets and strategic orientation of the parent company, however often the objectives of the two entities will be aligned.

The **team start-up** has several founders. The relevant literature does, however, not agree in the interpretation of the term "team". Some authors designate a start-up founded by two to three founders as a partnership, while using the term team only for a size of four to eleven members [Krüger (2006)]. Team start-ups can be described as advantageous with regard to the combination of possible complementary but also similarly oriented resources, e.g., the provision of technical knowledge and know-how, equity capital or individual contacts to potential suppliers and customers within a network. The individual founders possess specific experiences and competences, which they bring into the enterprise. In this way different strengths are combined and weaknesses are compensated for, which can contribute to an increase in the chances of a successful enterprise establishment and subsequent growth. In addition, this broader portfolio of competences sometimes allows for the minimizing of risks, for instance, compensating lacking technical know-how of the enterprise. In analogy to single start-ups, starting-up with a team of founders is also associated with specific advantages and disadvantages. One such advantage is the already mentioned increase in the contribution of resources as compared with the single founder. A larger number of founders also means that the work is better distributed across the founder group, so any over-stretching of the resources and time of individual founders can be reduced. However, potential delays and problems regarding the making, adjusting and implementing of decisions can be listed as disadvantages. Differing opinions but also competence disputes may represent a hindrance in the decision process. In the case of team start-ups, detailed initial (company) contracts must be agreed on by the individual founders, which will regulate, for example, the distribution of profits and losses, cost allocations, enterprise or capital shares, management and representation arrangements. In addition to contractual agreements, concord on the personal goals and orientation towards the objective and strategy of the jointly founded enterprise should be sought. It is important that the individual founders work together and not against each other. To achieve this, an open communication will be indispensable. One basic risk threatening the permanence of an enterprise is strong differences of opinions and disputes within the founding team, especially if the situation leads to the retirement of one or several founders. For this eventuality an individual exit strategy of the founders should be planned in order to minimize negative effects on the enterprise and to avoid distracting or demoralizing the staff. If not well-planned for, it is exactly the abrupt leaving of founders from the enterprise which can cause individual anxieties amongst the staff and thus poorly affect any entrepreneurial operational activities. For details regarding the implications of team start-ups, see Lechler/Gemünden (2003) as well as Gemünden/Högl (2001).

**Spinning-off** refers to the process of a dis-incorporation of a department or business unit from an existing enterprise (resulting in corporate spin-offs), a university or research institute (resulting in academic spin-offs). From one perspective, a spin-off can be considered as the dis-incorporation of a new business idea representing a new product-market combination which is to be realized through a new enterprise [Steffensen (2000)]. From this point of view, a spin-off is to be regarded as an original form of enterprise formation. However, a spin-off can also be understood as the dis-incorporation of already existing internal units and business activities into an independent enterprise (e.g., outsourcing); in particular, existing resources like personnel or technology may be transferred to the spin-off enterprise [Nicolaou/Birley (2003)]. According to this interpretation, a spin-off is a derivative form of enterprise because it utilizes an existing resource base or factor combination in its creation. [In this case, we can speak of a split-off instead of a spin-off. Note though that sometimes a split-off is also considered as an original form of enterprise formation. Here, the dividing line between spin-off and split-off is not the origin of the factor combination but the degree of acceptance by the parent enterprise: in a spin-off, the parent enterprise endorses and actively supports the spin-off business while in a split-off the new business is founded without the explicit approval and support of the parent organization.

Overall, the separation and definition of these two concepts vary in the relevant literature and are not uniform. In many practical forms and cases, however, no actual distinction is made between spin-off and split-off, thus both terms are seen as synonymous when referring to a dis-incorporation from an enterprise.]

A **joint venture** is a co-operation between at least two companies, resulting in the creation of a new, legally independent business entity in which the founding companies participate with their capital. The capital distribution can be equal, however there may also be deviations from this in practice. Depending on the participation structure, equal or unequal rights of the enterprise managers can be the result. In addition to the capital, the companies founding the joint venture usually also bring into the new enterprise a significant share of resources such as technology, patent rights, technical or marketing know-how and/or factory assets.

**Derivative Forms of New Venture Formation**

**Business takeovers** usually consist in the takeover of an existing business by a single founder or a founder team. In this context, the subject area of **enterprise succession** is important, especially in countries where a substantial SME sector evolved in the second half of the twentieth century. Enterprise succession reflects the transfer of a family enterprise managed by the owner to a male or female successor. As a rule, management powers and capital shares are handed over to the successor. In this case, the present entrepreneur will withdraw completely from the enterprise. In a wider sense, the concept comprises all cases of succession solutions in enterprises irrespective of whether these enterprises are family enterprises or not. [For enterprise succession as a specific form of enterprise formation see, for example, Leiner/Schmude (2003).]

In European countries a great many enterprises are set to be transferred to new owner-managers in the next few years because of the inevitable aging of the present owner-managers. For Germany, where enterprise succession is a particular challenge because of its large "German Mittelstand" sector, according to estimates of the *Institut für Mittelstandsforschung* (IfM Bonn), it can be assumed that annually approximately 71,000 enterprises will have to face such succession issues.

The purchase of an existing enterprise by internal executive employees is called a **management buy-out** (MBO). Executive personnel acquire capital shares of their enterprise and take over the management of the business. A management buy-out is, for instance, considered when an entrepreneur would like to withdraw from the family enterprise and there is no successor or no suitable successor within the family. The management buy-out is in this case a possibility of securing the existence of the enterprise. In a **management buy-in** (MBI) external management executives acquire capital shares of an existing enterprise and simultaneously take over the business management. In practice, combined solutions of management buy-outs and buy-ins can often be found. For example, this applies when the interested internal executives alone cannot produce sufficient capital or when the leaving of the present entrepreneur causes significant "know-how" deficits.

**Acquisition** signifies the purchase of a legally independent enterprise by another enterprise. In many cases the concepts acquisition, respectively take-over, and merger are used jointly. In order to separate acquisitions from mergers, it may be asked whether the transformation is made voluntarily or not. An acquisition can be carried out either voluntarily (friendly takeover) or involuntarily (unfriendly or hostile takeover) [see also chapter 7.4.4.2.1]. A **merger** is understood as the joining of so far legally independent enterprises which are "fused" into a new enterprise. In contrast to an acquisition, a merger is principally carried out on a voluntary basis by the enterprises [see also chapter 7.4.4.2.1].

A **split-off** means splitting away from an existing enterprise with existing factor combinations, i.e., transferring a part of the assets of an existing company to a new enterprise. Hence, this form of enterprise formation must also be classified as a derivative new business formation (also note the exception in the classification of spin-offs and split-offs briefly discussed above). Depending on the understanding of the concept, a split-off is also seen as a specific form of spin-off.

**Mixed Forms**

**Franchising** is a hybrid form between an original new enterprise and a derivative form of enterprise formation based on existing resources. Franchising refers to a distribution system with vertical-cooperative organization of legally independent enterprises. The franchisor provides the franchisee with a franchise business concept and, in return, the franchisee has to pay a financial compensation, which entitles and obliges the founder to use this franchise. The aim of the franchisor is to build a sales-promotion and distribution system for his/her business concept based on a partnership sales system under a uniform marketing concept. The franchisee makes use of an established business concept which usually has already proved itself successful in the market [see also chapter 7.4.4.3.4].

The systematization of forms of new enterprise formation shown above can be extended or modified using additional dimensions. As an example, the classification according to the **degree of innovation** could be subdivided into *innovative, imitative* and *multiplicative types.* **Innovative** refers to the *first utilization of factor combinations* and therefore to something new. **Imitative** new enterprises are based on an *already existing and well-known factor combination* and its use *with slight modifications*. **Multiplicative** characterizes the *repetition of existing factor combinations in exactly the same manner.* The latter type of multiplicative new enterprises refers primarily to the special group of franchising businesses, as clearly defined factor combinations are transferred by the franchisor to the franchisee and put into practice in the form of an enterprise. Any extension of the described structure would then be built as a three-dimensional representation of the so far two-dimensional matrix.

## 1.2 Ethics, Enterprise Culture and Entrepreneurship

Generally speaking, ethics examines the question of the norms for the “right” behaviour which can be justified from a moral point of view. It is a discipline which in general gives a description, comparison, evaluation and in the core a reflection of human actions, in which the “good” actions or the “Good” in life form the centre of observation. It is a question of responsible acting which takes into account the interests of everybody concerned. In this context, “ethics” describe a set of *plantable norms* and *values*, which are designed to serve humans as orientation for their actions [Smith (2001); Bombassaro (2002); Macharzina (2003); Pieper (2003)].

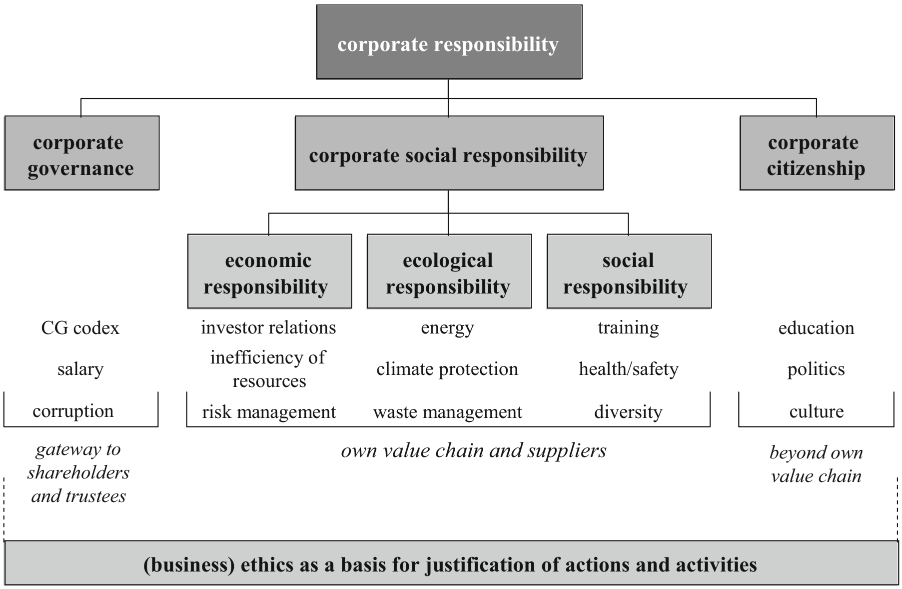
Good or bad actions are increasingly discussed and assessed within the economic and in particular within the entrepreneurial context. This critique does not only apply to established large-scale enterprises, but also to young enterprises, which have come in for strong public criticism in the wake of the stock-market crisis from 2000 to 2003 and the spreading worldwide financial crisis in 2008/2009 (which began in the sub-prime mortgage market and then spread to the general stock-market and beyond).

### 1.2.1 Business Ethics

In the large number of theoretical papers on *business ethics*, there is neither conceptual clarity nor a conceptual consensus as regards its meaning. In addition, the meaning of this term does vary between different cultures, for there seems to be evidence that business ethics vary by country, with historically large differences existing even between developed capitalist countries. So there is no overall consensus. [Clarke/Aram (1997); Vogel (1992)]. In fact, different concepts are associated with **business ethics** and often used synonymously with "ethics" in business (via specific terms such as *compliance, integrity, risk management, codes of conduct, sustainability*, but also encompassing general *corporate cultures* as well as their *mission statements.*) In the current discussions, business ethics are perceived as connected *inter alia* with concepts of *corporate social responsibility (CSR), corporate responsibility (CR), corporate citizenship (CC), entrepreneurial (corporate) responsibility* and *corporate governance (CG).*

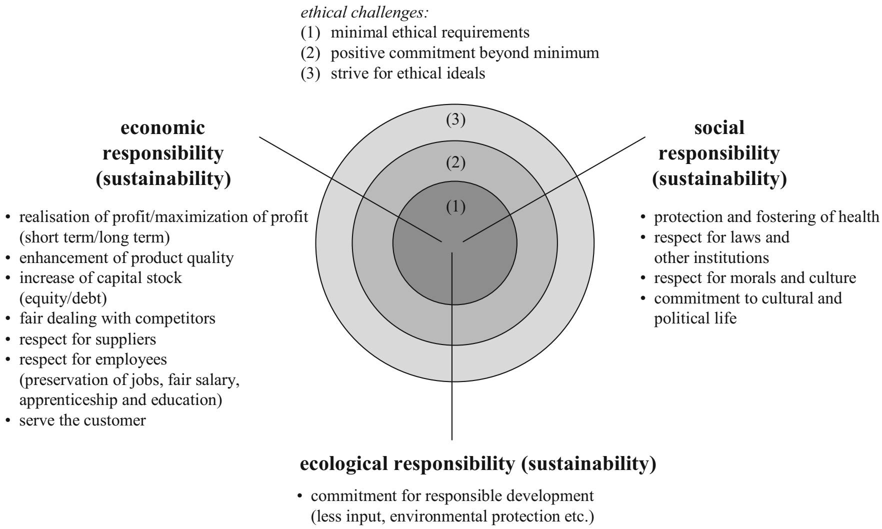
Illustration 1-4 shows the relationship between (business) ethics, corporate (social) responsibility and other terms in this context [Tokarski (2008); Bassen/Jastram/Meyer (2005)].

***Illustration 1-4:*** *Ethics and corporate (social) responsibility*




Generally speaking, the concept of **corporate social responsibility** comprises **economic, social** and **ecological aspects.** These three aspects are also called the **triple-bottom line**. [Other concepts associated with business ethics are *corporate sustainability*, *sustainable development*, *social sustainability*, *social (performance) management*, *reputation management*, *stakeholder management* and *value management*.] It has to be noted that, depending on the author and point of view, the triple-bottom line is used within the context of *economic, social and ecological responsibility* and sometimes within the context of *economic, social and ecological sustainability*. The concepts of responsibility and sustainability are closely connected. Illustration 1-5 shows the triple-bottom line and its connection to ethical aspects [Tokarski (2008); Enderle (2004)].

***Illustration 1-5:*** *Triple-bottom line*




The multiplicity of different concept usages makes it difficult for enterprises to decide what is a conceptual approach, an implementation measure, an instrument or a method for target-orientated business ethics. In theory and in practice, the concepts are often discussed not dispassionately, but very emotionally, with reproaches ranging from a lack of scientific justification to the absence of necessary business-ethics components. The multitude of the concepts used in the context of business ethics can be seen as an attempt to concretize the values of an enterprise, leading to them being perceived as varied forms of concrete business ethics. In contrast to the concept of business ethics, the concept of values appears to be easier to comprehend via linguistic concepts. The search for suitable concepts in this context is accompanied by the concern of establishing a responsible acting practice for enterprises and implementing it within them. In short, values, ethics and corporate social responsibility are not mutually exclusive, for they are interrelated and (somewhat) interdependent [Tokarski (2008); Joyner/Payne/Raiborn (2002); König (2002); Kokot (2002); Nehm (2002)].

The reason for the **necessity of business ethics** lies, *inter alia*, in the *negative external effects of economic activities* (externalities) with their social and ecological costs, which cannot be avoided completely in the market process, nor (in some cases) eliminated by any conceivable improved framework. Moreover, the further development of an institutional framework has a primarily *reactive* nature, i.e., institutional or regulatory frameworks always adjust to the changing economic, technical, cultural and social conditions with a certain time delay. In this context, we can speak of a systemic deficit.

The result of the increasingly faster scientific, technological and economic developments is an ever-growing demand for adjustments of the institutional framework. To some extent, enterprises in the areas of new technologies, such as, for instance, genetic engineering or internet technology, are sometimes operating without any institutional framework, being too new for an appropriate institutional form to contain them. Damages and problems caused by such missing institutional frameworks can have significant effects on society. A further systemic deficit of the institutional framework consists in the fact that control and sanction facilities or mechanisms cannot always be enforced and carried out in a society. Thus, not all socially undesired actions can be detected, prevented or sanctioned. The practice of business ethics could, in this case, work as a corrective where, for instance, an institutional framework does not yet exist or is not yet adequately defined [Tokarski (2008); Hanafey (2003); Gerum (1992); Enderle (1991); Homann/Blome-Drees (1992)].

When reflecting on the sense of the phrase, "business ethics" means ethics related to the enterprise. Therefore, the core of business ethics is the occupation with the standards and **values of an enterprise**, with its morality; as every enterprise stands for definite standards and values and possesses a morality which, however, is not always apparent. The standards and values of an enterprise may, nevertheless, be determined on the basis of the *products offered,* the *interaction with the co-workers* or also the *effects of the production on the co-workers and the environment*. Within the entrepreneurial context, the values, virtues and standards of the entrepreneur or the entrepreneurial team have a huge impact on the enterprise itself and its members, e.g., the employees and their values. Several researchers have noted links between individual characteristics and corporate ethical orientations as well. In this context, research regarding the cognitive moral development (CMD) of individuals in general and entrepreneurs in particular has been recently undertaken [Tokarski (2008); Buchholz/Rosenthal (2005); Solymossy/Masters (2002); Hisrich/Bucar (2001)].

Within business ethics, *issues of ad-hoc conflicts are also to be broached*, which refer to individual enterprises or industry sectors and which therefore cannot be generalized now or in the future. For this reason, business ethics often aim for individual commitment or voluntary agreements between the participants. To put it abstractly, the core of the business ethics is a communal definition of material standards and operational guidelines that request the sector‘s enterprises to either carry out or refrain from certain actions in a certain situation. Modern forms of business ethics do not call into question the entrepreneurial principle of profit realization. However, it is the specific form of profit realization or economic activity which is of importance [Tokarski (2008); Hisrich/Bucar (2001)].

According to Berkel/Herzog (1997), the following objectives are to be pursued within business ethics:

- Sensitizing the consciousness for the perception and incorporation of ethical aspects into the typical workday.

- Enabling the presentation and reflection on ethical concerns within the framework of problematical decisions.
- Elaborating decision rules and procedures which can be applied to ethical issues.
- Initiating an enterprise-wide dialogue about the fundamental values and binding standards with the aim of finding an amicable consensus.
- Ensuring everybody's commitment to common values and decision standards independent of outside influences.
- Inducing a self-critical verification and rational justification of the value-related convictions and moral stances of co-workers.
- Raising awareness for the conditions which have to be changed in the working environment of each individual with the goal of making moral acting possible.
- Enabling co-workers to act in accord with their own fundamental convictions and in this way creating productivity.

With regard to the realization of practice-related business ethics, the following questions should be answered, according to Dierkes/Zimmermann (1991):

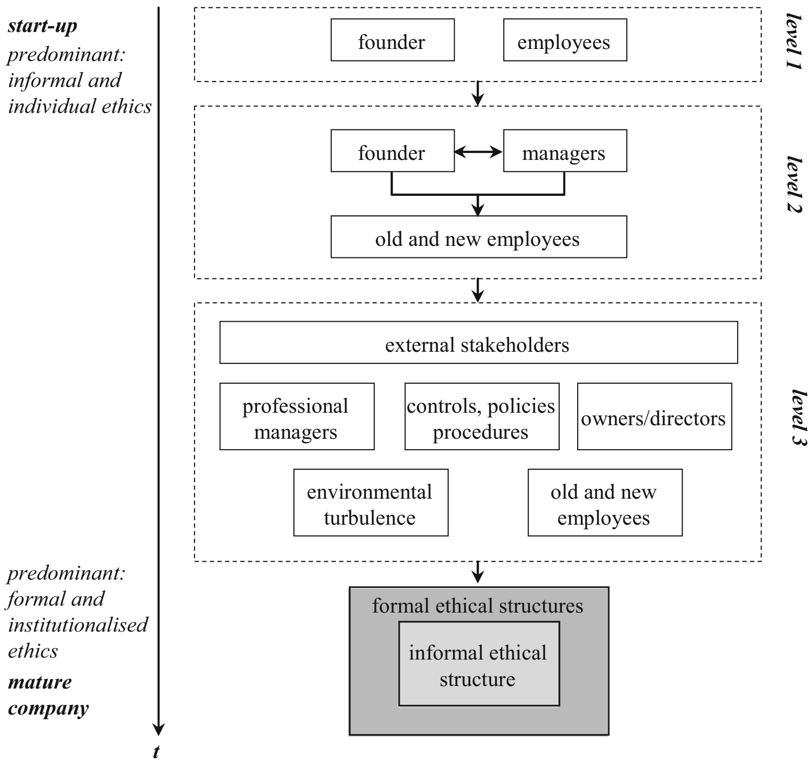
- How are technical-ethical aspects to be considered within the context of entrepreneurial-ethical concepts?
- How can business ethics be developed within the framework of life-benefitting and economic actions in a multi-cultural value and culture space?
- How can the integration of business ethics into the organization culture of an enterprise be realized?
- Does an examination of the relationship between individual ethics and institutional ethics take place, in which a one-sided weighting is regarded as a deficit?
- How are business ethics in the form of institutional ethics developed or concretized with regard to the responsibility and governance of the entrepreneurial organization as such?

### 1.2.2 Ethics as a Challenge for a Young Enterprise

In the general understanding of the public it is often assumed that **economy and ethics** are two mutually excluding concepts and must therefore be considered as incompatible with each other [see, for example, Machan (1995)]. Although it is not possible to examine this supposed opposition here in depth, some selected areas of the relationship between ethics, economy and young enterprises will be discussed in more detail in the following.

Entrepreneurial behaviour is often measured and judged exclusively by economic criteria. From the purely economic point of view, for instance, entrepreneurial activities generally aim for success or specifically for profit. Economic behaviour in the form of profit-making through entrepreneurial activities, for example, does not necessarily mean that the management and staff of an enterprise behave unethically, as diverse internal and external factors influence the behaviour of people in an enterprise. Internally, the entrepreneurial personalities set the norms, in particular in young enterprises, as they decisively influence the perception and action-pattern of the staff. The business management is largely responsible for whether the acting maxims are only determined according to economic principles or whether ethical principles and actions play a role as well. Moreover, the staff members also have an influence on the ethical or unethical conduct in a young enterprise. A deliberate encouragement of ethical behaviour and responsible acting in the staff facilitates the development of a young enterprise culture based on ethical acting maxims. Thus, with the growth of a young enterprise arises the opportunity that at an early point values and norms oriented towards ethical acting and conduct become manifest in the enterprise culture [see Hanafey (2003)]. Therefore, in theory, both informal and individual ethics, influenced by the founder and the employees, are predominant within start-ups. As the enterprise evolves over time, the ethical characteristics of the enterprise change. In (more) mature enterprises, formal and institutionalized ethics are predominant. Illustration 1-6 shows a theoretical framework of ethical enterprise development [Morris et al. (2002a); Tokarski (2008)].

***Illustration 1-6:*** *Ethical enterprise development*



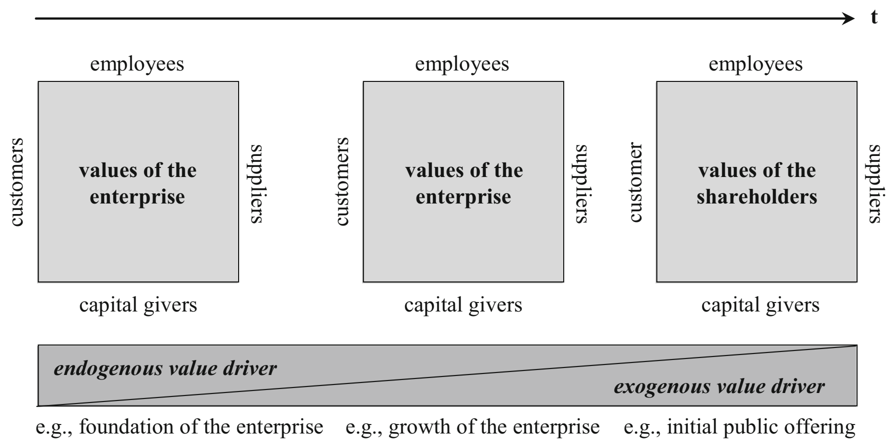

Ethical challenges also face the enterprise from outside. For example, in young enterprises which are planning to deal on the stock exchange or have already done so, specific areas of tension often develop, which can have a negative influence not only on the enterprises themselves but also on their surroundings. Against the background of the experiences from the so-called "dot.com"-euphoria at the end of the last century, these problems become clear. Unethical behaviour in the widest sense is not only encouraged or made possible by the economic activities of an enterprise, but also through the *mechanisms of the capital market*. In a positive sense, the stock-exchange allows young enterprises access to ownership capital. In an ideal case, this leads to a "win-win" situation for the young enterprise and its investors as long as the enterprise grows, develops economically and its growth is reflected in the share price or the enterprise value. However, *negative effects* can also be listed, which may, for instance, be caused by the exploitation of the financing capabilities of the stock exchange through the use of fraudulent business models. Enterprises quoted on the stock exchange are generally subject to the pressure of having to fulfil the expectations of the stock exchange, which rewards above all turnover and profit-growth of an enterprise. Some young enterprises quoted on the stock exchange were evidently only able to meet the expectations of security analysts and investors by manipulating and falsifying their annual balance sheets. Young bearers of hope, as, for instance, the German enterprises *Phenomedia* or *Comroad,* suddenly turned into cases of fraud under criminal law. Such examples of young enterprises illustrate that in individual cases any ethically responsible acting is neglected or non-existent in order to achieve the aspired economic success. The fact that any acting of an enterprise oriented exclusively towards its economic success is often judged negatively by the public is thus understandable. Through the employment of activities which in principle are to be classified as criminal, not only young enterprises and their staff are damaged, but also many other interest groups such as customers, suppliers and financiers. Unethical acting of the management can have a negative effect on regions and even the complete economy of a country, far beyond the effect it has on the value creation chain of the respective enterprise itself.

Although it is true that young enterprises, in particular, came under the criticism of the public through some negative events in the stock exchange, one must be aware that cases of fraud can also occur in established large enterprises. The North-American enterprises *Enron* and *WorldCom* quoted on the stock market have contributed to the interest of the public and scientists in ethical questions with reference to enterprises, an interest which has generally increased during the last few years. Within the framework of the present textbook, however, the specific interest is focussed on ethical problems in relation to young enterprises in particular. As an example of the discussions about the problems of the new economy, reference is made to the film by Klaus Stern *World market leader – the story of Tan Siekmann.* This documentary deals with the events surrounding the rise and fall of the (German) enterprise *Biodata AG* and paints a portrait of the founder and board member Tan Siekmann.

As already shown in an example, young enterprises can be confronted in many ways with ethical questions and difficulties in the course of their development. This does not only concern young enterprises listed on the stock market but all young enterprises. *Methods applied in winning customers, the treatment of colleagues* or *planning and developing production, distribution and market strategies* can sometimes be judged critically from an ethical point of view.

A young enterprise is embedded in a specific *ecological, technological, economic, legal* and *social environment* with diverse relationships to different **stakeholders**, e.g., *employees, colleagues, suppliers, capital providers, competitors, customers* or *the state.* All stakeholders have values and norms at their disposal, which are associated with *certain expectations* and *intended behaviour patterns.* With the help of norms, fundamentally desired actions or action patterns are to be generated and channelled. It has to be appreciated that the values and norms of an enterprise are neither determined nor stable over time. They evolve like the enterprise evolves in other aspects, e.g., from the start-up to the growth phase. Within the start-up phase, there are more endogenous value drivers of importance like the entrepreneur's value system. During the development process, more and more exogenous value drives come into force which complement or (sometimes) replace the former value system driven by the value set of the entrepreneur(s) [Tokarski (2008)]. Illustration 1-7 shows the change of values within an enterprise [Wieselhuber (2000); Tokarski (2008)].

***Illustration 1-7:*** *Change of enterprise values over time*



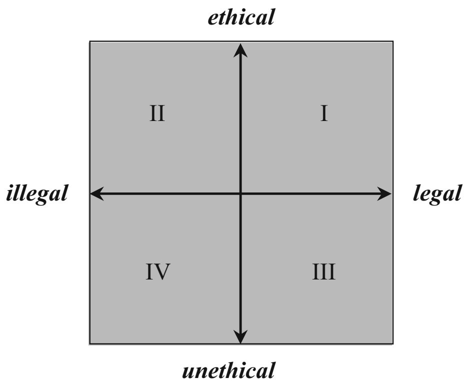

As the present textbook is specially geared to the context of young enterprises, diverse problem areas or divergences between intended norms and practical behaviour can be observed. Young enterprises exist in a multi-layered **intra-** and **interpersonal, enterprise-internal** and **enterprise-external field of tension.** On the one hand, there are the concrete demands and challenges, such as the provision of:

- Security and growth of the enterprise through good house-keeping,
- Job security, i.e., responsibility for the staff,
- Security of the environment and an ecological balance, also in the interest of future generations,
- The fulfilling of customer needs.

On the other hand, a situation of conflict can be caused by the entrepreneur or founder striving for *individual maximizing of profit*. This situation can be seen as a direct result of the tension between ethics and self-interest. In the centre of ethical observations lies the relationship between morality and self-interest. Self-interest should not be relinquished in favour of morals nor should morality be given up in favour of self-interest. In essence, morality and self-interest must be interdependent for a mutual advantage [Suchanek (2001)].

Young enterprises take a general **legal-ethical position** between the contrasting poles of *legality/illegality* and *ethicality/unethicality.* This position comprises aims, strategies, and measures regarding entrepreneurial actions. In this connection, specific norms can evolve from the individual conduct of a young enterprise, which manifest themselves in the enterprise culture. For young enterprises, this relationship of tension is highly significant as they see themselves faced with the dilemma of securing the existence of the enterprise and, at the same time, *generating growth* through the employment of target-oriented strategies, measures and actions. A large number of diverse advantages and disadvantages, chances and risks as well as moral points of view within an interdependent individual or social norm system have to be taken into account. The practical classification or development of the individual strategies and measures for securing the permanence of the enterprise in the tension relationship between *legal/illegal* and *ethical/unethical* is to be considered *individually* and *situationally* in relation to the individual case. Illustration 1-8 shows generic ethical-legal dimensions [Henderson (1982); Kumar/Sjurts (1991); Gerum (1992)].

***Illustration 1-8:*** *Ethical-legal dimensions*




A decisive factor is the basic ethical attitude of the entrepreneurial personalities and the consideration of their values and norms with regard to personnel management. The individual attitude and disposition of the entrepreneur or founder has a decisive influence on the orientation of the enterprise. Decisions regarding legal/illegal and ethical/unethical behaviour can be described as “pull” factors, which the entrepreneur wants due to his/her specific disposition. Conversely, "push" factors arising from pressure from the general or individual enterprise environment are also important.

In this context, there is a general problem regarding the *perception* of an aim, strategy or behaviour as ethical or unethical. [For further research and scales on the perception of (business) ethics see, e.g., Singhapakdi et al. (1996); Etheredge (1999).] The evaluation of an aim, strategy or behaviour becomes problematic when internal and external factors influence choice and application. Let us assume the following example: A founder starts out to produce bio-furniture of high ecological quality. Production and marketing of the bio-furniture start successfully. What will, however, happen if an external pressure arises, such as price-pressure from new competitors? This could lead to a situation in which the entrepreneur uses cheaper materials for his/her production which no longer fully meet the originally claimed ecological quality norms. The entrepreneur is then confronted with a conflict, as he or she can no longer achieve his/her original aim of producing ecological furniture because of the external competitive pressure. Nevertheless, they would still like to declare the produced furniture as "bio-furniture". This example illustrates how the founder or entrepreneur can be forced to generate a balance between ethical demands, economical requirements and social responsibility. [In this context, the question of how labels and standards are set, e.g., by the forest stewardship council (FSC), come into play, which is relevant in the context of corporate social responsibility (CSR). For basic definitions of CSR see, for example, Smith (2003); Sethi (1975).]

In summary, the explanations of this section are designed to point to selected ethical problems of young enterprises and to make the reader think. The presented subject group, which could only be presented in parts using the example of young enterprises in the context of the capital market, is extremely complex. At the same time, there is still a demand for empirical investigations within the framework of entrepreneurship research, which would throw light on the relationships between ethics, economy and young enterprises in a comprehensive and detailed manner.

### 1.2.3 Ethical Orientation for Young Enterprises

The relevant literature contains various **ethical approaches**, which can and should be adopted by an enterprise. Basically, *utilitarian ethics, Kantian, virtue-oriented ethics, value-oriented ethics, contractualism* or *natural rights theories* like Hobbes in different practical forms can be identified. [In theory many more approaches can be identified which may be categorised in different ways.] These approaches are in some cases closely interconnected and represent different possible entrepreneurial ethics. Often, they are also classified into *deontological* (duty) and *teleological* approaches (purpose, aim) [Smith (2001); Curran (2002); Lahdesmaki (2005); Buchholz/Rosenthal (2005)]. Due to their high complexity, individual approaches cannot be studied in depth in this book. However, on the basis of a value-oriented approach, selected aspects will be discussed which will contribute to the understanding of the demands or requirements of ethics for enterprises in general and specifically for young enterprises.

According to Goodpaster/Mathews (1982), the central question within the discussions surrounding the concept of **ethics of organizations** is whether an enterprise has a conscience [see also Goodpaster (1982)]. The answer is yes when looking at the enterprise as an entity to which ethical qualities and positions are ascribed as they are to human individuals. This view leads to the creation of entrepreneurial ethics which go beyond the individual person. According to this approach, three aspects are of fundamental importance for the founders with regard to management or in the context of new business formation:

- An orientation of the enterprise strategies according to ethical concepts of value
- an institutionalization of ethical motivations in the organization members
- a long-term sustainable ethical orientation, e.g., in the form of guidelines, which are also authoritative for succeeding generations.

Based on this fundamental understanding of entrepreneurial ethics, the *enterprise leaders* have both an *internal* and *external responsibility.* Within the framework of **internal responsibility** the *creation of moral internal norms* is the aim. This internal responsibility expresses itself practically in the way the entrepreneurs treat themselves and their staff. As regards the staff, the internal responsibility finds its concrete expression when converted into an ethical personnel policy. For sustainably lived ethics in a young enterprise, it can also be beneficial to draw up general ethical guidelines for the organization. Internally generated ethical orientations and norms do not only have an effect inside the enterprise. While they are *based* primarily on an *internal responsibility* towards the staff, they also affect external target groups. At the same time, these internal norms are to be seen as interdependent with the entrepreneurial environment and an external responsibility. Enterprises or entrepreneurs have a social responsibility, i.e., an **external responsibility** as illustrated, for example, in the adherence to the current conventions and legal requirements. Within this meaning, the legal minimum requirements, e.g., with regard to environmental protection measures, must be met sustainably also for the protection of future generations. In individual cases, the enterprises also take voluntary measures for the protection of the environment, although they are not prescribed by law. It is true, however, that such voluntary measures do not always have an ethical motive, but are frequently designed to improve one's image – for example, as a chemical business – and to distinguish oneself in this way from the competitors in the eyes of the public.

From the practical point of view, it is immaterial whether the development of ethical norms or requirements is due to internal or external responsibilities or to any other motivation. In general, however, it is important for young enterprises to define ethical requirements. The observance of ethical requirements in principle refers to *all* areas of the enterprise. Examples of ethical responsibility are numerous. Within the framework of *research and development,* the respect for life and any effects of research activities on living beings can be of crucial importance. In the field of material *procurement,* it can be relevant that materials are produced in an environmentally friendly manner and that there are safe working conditions for the *production.* In the area of *marketing,* graphic, truthful and easily understandable product descriptions can be highly significant, e.g., for a sustainable customer relationship. The leadership style of the management or the founders as well as the internal and external communication are important for all areas of the enterprise. In conclusion, these examples illustrate that a *management acting according to ethical principles* is also of crucial importance *for a young enterprise.*

The adoption of internal and external responsibilities can be seen as mutually dependent. Ethical positions, orientations and norms with regard to different *internal* and *external target groups* or *stakeholders* must be taken into account. **Internal target groups** within the framework of the internal adoption of responsibility are the *staff* of the enterprise. **External target groups** are, for instance, *customers, suppliers, competitors, politicians, authorities, educational institutions, pressure groups, financiers* as well as the *state* and *society*.

In the course of the last few years, the public has become increasingly aware of the complexity of ethical topics and has even sometimes demanded ethical behaviour. In this, ethics and economy form a joint continuum. Especially in enterprises involved in the growing process, *formal* or *informal* and *voluntary* or *binding* ethical norms and orientations are required, which should be followed in the economic process. An example of a voluntary commitment which reaches into the area of *corporate social responsibility is the* **United Nations Global Compact** [www.unglobalcompact.org]. This is a pact agreed upon by enterprises and the United Nations. The pact is a voluntary initiative for the promotion of social engagements of enterprises, with the purpose of making globalization more social and ecological. The Global Compact is based on the ten principles of a worldwide consensus derived from the *General Declaration of Human Rights,* the *Declaration of the International Labour Organization concerning the Basic Principles of the Rights at the Workplace,* the *Rio Declaration concerning Environment and Development* and the A*greement of the United Nations against Corruption.*

The ten principles of the Global Compact are as follows [United Nations (2009)]:

**Human Rights**

- *Principle 1:*
  Businesses should support and respect the protection of internationally proclaimed human rights; and

- *Principle 2:*
  make sure that they are not complicit in human rights abuses.

**Labour Standards**

- *Principle 3:*
  Businesses should uphold the freedom of association and the effective recognition of the right to collective bargaining;
- *Principle 4:*
  the elimination of all forms of forced and compulsory labour;
- *Principle 5:*
  the effective abolition of child labour; and
- *Principle 6:*
  the elimination of discrimination in respect of employment and occupation.

**Environment**

- *Principle 7:*
  Businesses should support a precautionary approach to environmental challenges;
- *Principle 8:*
  undertake initiatives to promote greater environmental responsibility; and
- *Principle 9:*
  encourage the development and diffusion of environmentally friendly technologies.

**Anti-Corruption**

- *Principle 10:*
  Businesses should work against corruption in all its forms, including extortion and bribery.

Against this background, the Global Compact demands that enterprises recognize, support and put into practice a catalogue of basic values within their sphere of influence. These are values in the areas of *human rights, work standards, protection of the environment* and *the fight against corruption.* At the same time, it should be noted that the principles of the Global Compact represent minimum standards, which in most countries of the world are binding under international law. Yet, there is no legal obligation to follow these specific guidelines. The Global Compact can be seen as a means of implementing ethical responsibility, if the principles are put into practice. The Global Compact can, for instance, also serve as a basis for contracts with suppliers, in order to preset minimum standards in a value-creation chain, which then have to be observed contractually. Young enterprises can, as suppliers for other enterprises, also be bound to observe the minimum standards of the Global Compact or any other standards. Such **standards** are for instance the *SA8000* (Social Accountability 8000), *AA1000* (AccountAbility 1000), *GRI guidelines* (Global Reporting Initiative) or the *OECD guidelines* (Organisation for Economic Co-operation and Development). Furthermore, specific labels or official seals in the context of social or ecological aspects certify that the company acts according to these official **social or ecological standards**, e.g., in the field of production. Examples for such labels are *ISO 14001* (environmental management), *FSC* (Forest Stewardship Council), *MSC* (Marine Stewardship Council) or *Fairtrade*. Moreover, young enterprises can demand that their international suppliers observe specific standards. The aspects described above are closely related to ethical issues.

In conclusion, the following questions should assist the reader in reflecting about the ethical context of entrepreneurship:

- For whom is the enterprise responsible from an external as well as internal point of view?
- What are the desirable ideal ethical norms of the enterprise?
- What is the relationship of these norms to economic targets?
- What are the problems with regard to a desired implementation of these norms?
- How can a long-term safeguard of the ethical orientation of the enterprise be ensured?
- How can employees be motivated to realize, observe and export desired ethical orientations?

### 1.2.4 Social Entrepreneurship

Finally, in terms of an ethical orientation of young enterprises there is a specific form of more or less altruistic activity of entrepreneurial philanthropy: **social entrepreneurship**. "More or less" means that social enterprises may be placed on a spectrum between non-profit (with a high social return) and for-profit businesses (with a high financial return) [see John (2006)]. The former are, e.g., charities who cover their operating costs completely from fund-raising sources; the latter may be traditional profit-maximizing corporate businesses with the business model of social enterprises located between these two extreme forms. [Also see the differentiation of social business models in Yunus (2006) – ranging from no cost recovery, some cost recovery, and full cost recovery to more than full cost recovery.] Illustration 1-9 shows a continuum of options for setting up socially-oriented enterprises alongside three generic categories: purely philanthropic, hybrid and purely commercial [adapted from Dees et al. (2001)]. Depending on these three categories, there are different benefits and returns of stakeholders who commit resources to a social enterprise.

*Illustration 1-9:* *Social enterprise spectrum*

continuum of options

| | purely philanthropic | hybrids | purely commercial |
|---|---|---|---|
| **general motives, methods, and goals** | ▪ appeal to goodwill<br>▪ mission-driven<br>▪ social value creation | ▪ mixed motives<br>▪ balance of mission and market<br>▪ social and economic value | ▪ appeal to self-interest<br>▪ market-driven<br>▪ economic value creation |
| | **key stakeholders** | | |
| **beneficiaries** | pay nothing | subsidized rates and/or mix of full payers and those who pay nothing | pay full market rates |
| **capital** | donations and grants | below market capital and/or mix of full payers and those who pay nothing | market capital rate |
| **workforce** | volunteers | below market wages and/or mix of volunteers and fully paid staff | market rate compensation |
| **suppliers** | make in-kind donations | special discounts and/or mix of in-kind and full price | charge market prices |

In the middle of the above continuum within the hybrid category, a further differentiation of types of social enterprises may be made, depending on the reliance of the business model on business revenues as well as on the returns to investors. This sub-spectrum of new business formation within the social entrepreneurship domain according to John (2006) is depicted in Illustration 1-10:

*Illustration 1-10: The continuum of social entrepreneurship*

| charity organizations | | revenue generating social enterprises | | | socially responsible business | traditional business |
|---|---|---|---|---|---|---|
| funded by donations only | revenues from business and donations | >75% of costs covered by business revenues | 100% of costs covered by business revenues | generation of profits (100% of earnings retained) | socially motivated business; profits to be distributed to investors | profit maximization |

As in the case of entrepreneurship, in general there is a myriad of definitions of social entrepreneurship. Usually, these attempts to capture the essence of social entrepreneurship all share the idea of "exploiting entrepreneurial opportunities for social change and improvement, rather than profit maximization" [Zahra et al. (2008, 4)]. The authors themselves further define the theme to comprise activities and processes of opportunity discovery, evaluation, and exploitation with the aim to build social wealth by founding a new venture or managing corporate innovations which have a positive social impact. A well-known example of a social entrepreneur is Muhammad Yunus, founder of Grameen Bank, which offers micro-loans to poor people in Bangladesh who want to initiate their own entrepreneurial project or small business but have difficulties to obtain a regular bank loan at affordable rates of interest. [See www.grameen-info.org; more examples of social entrepreneurs can be found in Martin/Osberg (2007).] However, there are also other activities that social entrepreneurs engage in, often in areas like health care, education, community development, or environmental protection [Nicholls (2006); see Vyakarnam (2009) for approaches to integrate disadvantaged people into entrepreneurial activites world-wide]. Generally, typical activities social ventures engage in are, for example [Nicholls (2006, 14); also cf. Smallbone et al. (2001)],

- To provide goods and services which the market or public sector is either unwilling or unable to provide
- To develop skills
- To create employment
- To foster pathways to integrate socially excluded people.

Alongside these sectors and forms of activity, social enterprises are positioned to fulfil one or more of the three dimensions sociality, innovation, and market orientation. [Nicholls/Cho (2006); the example of Grameen Bank from above falls into the intersection between sociality and market orientation; efforts made by social enterprises in the renewable energies sector may fall into the categories of innovation and market orientation.] As for the drivers underpinning the growth of social entrepreneurship worldwide [cf. Bornstein (2004)], there are both supply and demand side issues, e.g., increase in per capita wealth, better education levels, improved communications (supply side), rising crises in environment and health, rising economic inequality, institutionalization of professional NGOs, inefficiencies in public service delivery (demand side) [Nicholls (2006)]. Concerning the latter point, the 2008-2009 global financial crisis, which left governments with rapidly growing deficits and overstretched budgets, may lead to an increased demand for social entrepreneurs to step in and offer goods and services formerly provided by public institutions (e.g., school infrastructure or care services). The economic issue of offering goods and services which are neither (or no longer) adequately provided by the public nor by the market is critical here. This can even be considered as a defining element of social entrepreneurship understood as "the pursuit of sustainable solutions to problems of neglected positive externalities" [Santos (2009), p. 1]. While the disregard of such problems by the public and the market defines a demand for the activities of social entrepreneurs, it nonetheless poses questions about how the business models of social enterprises should be constructed in order to be viable in society [cf. Elkington/Hartigan (2008)]. Above we have seen that the cost recovery through revenues from a social enterprise's own operations can differ, typically ranging from just above 50% (less would fall in the charity category) via 100% to 100% plus some profit (which usually remains in the enterprise to further support its social vision). There are different detailed approaches to systemize generic business or organizational models of social ventures. [See Alter (2006) for a very detailed overview of ways to build a viable business model for a social venture project.] Studies indicate that the financing sources (both internal and external) of social ventures are quite diverse with a focus on financing through foundations, sales revenues/fees, fund-raising/donations, and public sources [cf. SustainAbility/Skoll Foundation (2007)].

However, issues governing the viability of a social enterprises are broader than merely finding a financially viable niche between public and private sector financing instruments. In particular, the viability of a social venture and its offers will also depend on the overall societal acceptance and support of its business format. [Note that despite the euphoria about social entrepreneurship, there are also critical issues to be raised; see Dey/Steyaert (2009) who discuss possible paradoxes and ambivalences of the activity of social entrepreneurs at the societal level.] This is especially true for those social venture projects whose organizational form is novel (i.e., where services have formerly been provided by a public authority but not by a private business organization) and/or where goods and services are new with a lack of established financing norms. [For example, will target customers expect a social service to be for free or will a fee be acceptable or will society donate money or contributions in kind to sustain a social venture project and its mission?] In principle, there may be questions about the accountability of actors involved in social ventures [cf. Zahra et al. (2008)] and the legitimacy of its organization and offers [Nicholls/Cho (2006)]. The need for acceptance by society arises because a social enterprise may need, e.g., donators, volunteers, a supporting foundation, public support, or other vital resources to implement the entrepreneur's social vision [cf. Dart (2004)]. Because of their social nature, it may be comparatively easier for social enterprises to gain moral legitimacy as organizations; however, it may be more challenging for them to gain pragmatic legitimacy. The latter may involve concerns about the efficiency of the operations of the social venture, the intentions of its founders, the sustainable positive impact of the efforts, or the quality of product and service offers (in comparison to the alternative of a private for-profit business or the state to offer the same goods and services). [See Zahra et al. (2008), in particular for analysis of the (social entrepreneur) type, which the authors call the "social bricoleur". Social bricoleurs follow a predominantly altruistic value system by identifying local social problems and offering innovative solutions. However, there may well be concerns about the "efficiency of the allocation process they use in creating public good" (ibid., 12).] In other words, social entrepreneurs have to gain acceptance against the background of competing models of offering goods and services (be they public or private) and here "the increased emphasis on efficient and profitable market models dramatically clashes with many of the founding ideals of the public sector and NGOs dedicated to fostering the public good" [ibid., 12; also cf. Eikenberry/Kluver (2004)]. And within the very format of social entrepreneurship, which strives to combine elements of both sociality and market orientation, the underlying issue mentioned at the beginning of this chapter as to whether ethical behaviour and business economics are mutually exclusive may be one of the main concerns of external stakeholders to be addressed by the founders of social enterprises.

### 1.2.5 Enterprise Culture and Entrepreneurship

We have seen that numerous and diverse interdependences exist between the ethical orientation of an enterprise and the enterprise culture, as ethical fundamental attitudes and acting principles of the management and the staff decisively influence the culture of an enterprise. Yet, the enterprise culture can also shape the ethical conduct and actions of the enterprise management and staff. In addition, young enterprises have already, often without being aware of it, created a more-or-less distinctive specific culture. At the same time, management literature generally considers enterprise culture to be an important factor of influence on the entrepreneurial success.

Until now, there has been no general agreement about the concept of enterprise culture. There is a multitude of diverse terminological definitions which cover diverse aspects and criteria. Common to all definitions, however, is that enterprise cultures have historically grown changeable *norms, values and rules, thought and action patterns as they are applied in the enterprise.* They manifest themselves, for instance, in the behaviour of the management, in communication, decisions and actions [Macharzina (2003)]. Norms (standards) are target statements of behaviour requirements for people, which in essence are characterized by value judgements. The purpose of standards is the creation of intended forms of human behaviour with the demand to observe the established standards. This presupposes, however, a basic human freedom of action [Küpper (1999)].

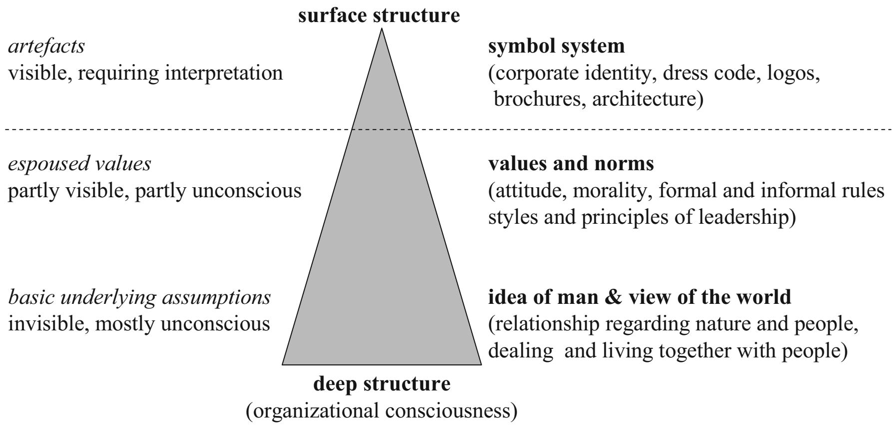
According to Schein (1997), an **enterprise culture** is based on three building stones, one placed on top of the other, the *basic underlying assumptions* (system of basic assumptions), the *espoused values* (norms and value system) and the *artefacts* (system of symbols). Within the framework of the enterprise culture, the **basic underlying assumptions** can be taken as the basis. They concern reality, the relationship to the environment, time and location, the essence of human nature, human actions as well as the relationships between humans. In the ideal case, the fundamental assumptions form a uniform basis for the thinking and acting of the organization members and their relationship to the environment. In the widest sense, ethical or moral attitudes can be included in these basic assumptions, such as, for instance, individual or communal reflections on our dealing and living with people or engaging with religious ideas. The basic assumptions form an unconscious basis for the actions of all those belonging to an enterprise.

There are different norms and values built on the system of the basic assumptions. The core of the enterprise culture is thus formed by the **espoused values** consisting of formal and informal rules, leadership styles and leadership principles. In many cases, they are at first not visible and tangible. However, the effects of values and norms can reflect themselves as *symbols of enterprise culture.*

The **artefacts** comprise *rites and rituals* (enterprise celebrations, joint sports activities, activities reaching beyond working hours, retirements, redundancies etc.), *myths and stories* (founders, founder epoch, enterprise development, successes and crises etc.) *corporate identity* (architecture, logos, dress, brochures, internet appearance etc.) as well as *enterprise atmosphere* (language, reliability, human contact etc.). For further details on this dimension, see also Schein (2003).

The culture of an enterprise can be seen as an "iceberg". Only a small part (or even merely the tip of the iceberg) is visible at the surface, i.e. the artefacts. However, most of the enterprise culture lies underneath the surface within the deeper structure of the organization and is represented by the espoused values and basic underlying assumptions. Illustration 1-11 shows the relationship between the different sections of the enterprise culture.

***Illustration 1-11:*** *Enterprise culture*

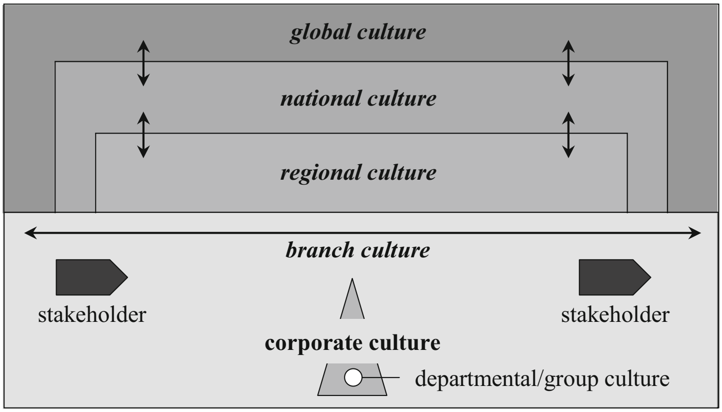



These general-concept demarcations can, at first, be taken to be the basis of any enterprise. Nevertheless, we can also presume that the enterprise cultures of recently founded or young enterprises have special features: The personalities of the founders are of great importance, in particular for young enterprises, for they are the central element of a start-up or young enterprise. In the development of young enterprises, the founders (consciously or unconsciously) often decisively shape the enterprise culture. Their direct influence on usually all members of the staff can lead to a strong identification of the staff with the enterprise so that the enterprise culture supports reaching those goals that the founders had intended. In this development phase of an enterprise, the founders can therefore be seen as the "crystallization point" of the enterprise culture. The founders also influence the further development of the enterprise culture in many cases by employing people who show norms and values similar to their own. In practice, however, this procedure can also be problematical, as it is not always easy to find employees who prove to have the attitudes and values desired by the founders. Thus, a vocational qualification can conflict with the desired values and norms of the potential employees. Whether a decision will be taken for or against the potential employee will depend in each case on the alternatives to this employee, as well as on the particular preferences of the founder persons. However, the enterprise culture can also be learned. As a rule, the employees take on (again, consciously or unconsciously) the value system of the young enterprise over their employment period. Here particularly, it is important to recognize that the culture, which has been decisively shaped by the founders, plays a significant role in the development of a young enterprise.

Nevertheless, it is sometimes not possible to influence the complete enterprise culture, as values and norms of social groups cannot be influenced and changed easily and quickly. However limited, the development of a sustainable enterprise culture can encourage the employees to identify themselves more strongly with the tasks and aims of the young enterprise, which again can lead to a positive influence on their motivation.

In this context it has to be noted that the enterprise culture is *embedded* within a global, national, regional, as well as an industry or branch culture with different stakeholders like competitors, investors or suppliers. These cultural layers are interdependent and the culture of the industry may embrace the regional, national or global cultural context. Illustration 1-12 shows different cultural layers and their interdependencies.

***Illustration 1-12:*** *Cultural layers*




A true global culture may not exist but in many countries some basic underlying assumptions or norms can be identified that have an influence on the other cultural layers. Cultural diversity has to be kept in mind by the management of enterprise organizations because it is an essential part outside and inside the enterprise and its very own enterprise culture. As such, cultural diversity will impact on the motivation and commitment of members of the organization as well as on the views outsiders hold about the enterprise in terms of its organizational image perceived by stakeholders.

# 1.3 Comprehension Test and Recommended Literature

## Comprehension Test

- Define in your own words the concept of entrepreneurship. (1.1.1)
- What are the most important features of it in your opinion? (1.1.1)
- What does the concept of creative destruction mean? (1.1.1)
- What does characterize a serial entrepreneur? (1.1.1)
- Describe the concept of corporate entrepreneurship. (1.1.1/1.1.4)
- Name and explain the typical demarcation features of young enterprises as compared to established enterprises. (1.1.5)
- What are the relative advantages and disadvantages of young enterprises? (1.1.5)
- What are the differences between innovative and imitative new enterprises? (1.1.6.1)
- Elaborate on potential advantages and disadvantages of establishing a new enterprise within a founder team as compared to founding it on your own. (1.1.6.2)
- Differentiate between original and derivative forms of new enterprise formation. (1.1.6.2)
- Which forms of new enterprise formation are there and how can they be graphically systematized? (1.1.6.2)
- Describe the relationship between ethics and economics. (1.2.1)
- Which areas of tension can be identified in the relationship between ethics and economics? (1.2.1)
- Outline the relationship between law and ethics. (1.2.1)
- Discuss the question whether an enterprise can have a conscience. (1.2.1)
- Which areas are assigned to an enterprise culture and why is the enterprise culture in young enterprises important? (1.2.5)
- What influence has the founder on the enterprise culture of a young enterprise? (1.2.5)

## Recommended Literature

### Entrepreneurship – Standard Works

*Allen, K. R.* (2003): Launching new ventures – an entrepreneurial approach, 3rd edition, Boston/New York 2003.

*Barringer, B. R./Ireland, R. D.* (2009): Entrepreneurship: Successfully Launching New Ventures, 3rd edition, Upper Saddle River, NJ, 2009.

*Burns, P.* (2007): Entrepreneurship and Small Business, 2nd edition, Palgrave Macmillan.

*Hisrich, R. D./Peters, M. P.* (2002): Entrepreneurship – International Edition 2002, 5th edition, Boston et al. 2002.

*Kuratko, D. F./Hodgetts, R. M.* (2004): Entrepreneurship: Theory, Process and Practice, 6th edition, Manson et al. 2004.

*Sahlman, W. A./Stevenson, H. H./Roberts, M. J./Bhidé, A.* (eds.): The Entrepreneurial Venture, 2nd edition, 1999.

*Sexton, D. L./Landström, H. (ed.)* (2002): The Blackwell handbook of Entrepreneurship, Malden et al. 2002.

*Timmons, J. A./Spinelli, S.* (2008): New Venture Creation: Entrepreneurship for the 21st Century, 8th edition, Boston et al. 2008.

### Entrepreneurship and Entrepreneur

*Bygrave, W. D./Hofer, C. W.* (1991): Theorizing about Entrepreneurship, in: Entrepreneurship Theory and Practice, 16th issue, no. 2, 1991, pp. 13–22.

*Shane, S.* (2003): A general theory of entrepreneurship. The individual-opportunity nexus, Cheltenham 2003.

*Shane, S./Venkataraman, S.* (2000): The promise of entrepreneurship as a field of research, in: Academy of Management Review, vol. 25, no. 1, 2000, pp. 217–226.

*Stevenson, H. H./Gumpert, D. E.* (1985): The heart of entrepreneurship, in: Harvard Business Review, vol. 63, no. 2, 1985, pp. 85–94.

# 2 Processes, Entrepreneurial Opportunity, Innovation

## 2.1 The Entrepreneurial Process

### 2.1.1 Aspects of the Entrepreneurial Process

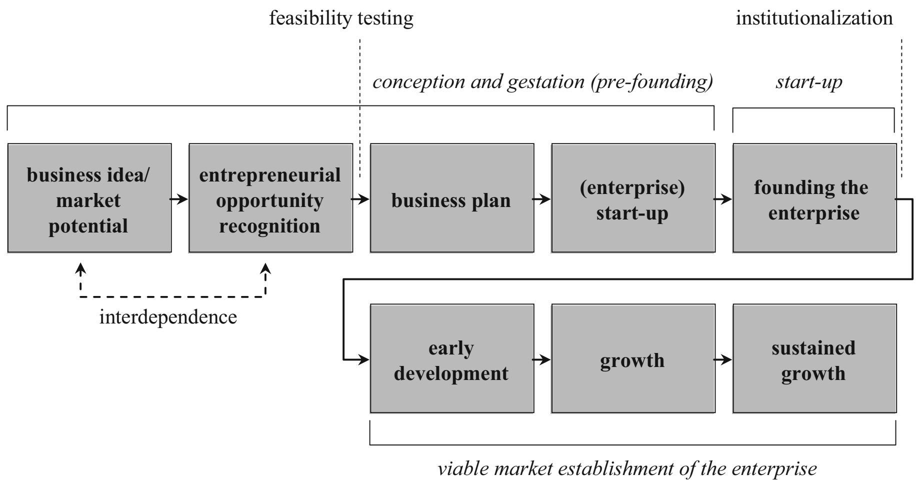
Definitions and explanations of the **entrepreneurial process** occur frequently in entrepreneurship literature. Often "entrepreneurial process" and "process of new venture formation" are used as synonyms. However, this book will not adopt this definition, as the *new venture or enterprise formation represents only a section of the entrepreneurial process*. Many of the explanations are derived from phase or life-cycle based models. In a simplified study of an ideal case, the entrepreneurial process comprises all functions, activities and actions which are associated with the *recognition* of an entrepreneurial opportunity, its evaluation and corresponding *development* of a business idea, as well as with writing a *business plan, establishing* an organization and *founding* of the enterprise itself*, taking into account* the required *resources,* ensuring the *viable market establishment* of the enterprise and the *achievement of growth* (opportunity exploitation) [Katz/Gartner (1988); Shane/Venkataraman (2000); Brush (2001); Allen (2003)]. Note that the process to establish a venture in the market place involves substantial sector heterogeneity – the steps which are necessary for establishing a restaurant business will differ considerably from those required for founding a high-tech start-up. [A good discussion of industry-specific entrepreneurship, e.g., in the technology domain, is offered in Dorf/Byers (2008)]

Illustration 2-1 shows the ideal-case structuring of the entrepreneurial process, which can be divided into the three super-ordinate main elements of *enterprise conception and gestation (prior to founding), founding the enterprise (start-up) as well as establishing the enterprise in the market place and managing its growth.* [For alternative approaches to systemize pre-organizational emergence, enterprise birth, establishment and growth see Grünhagen (2008), p. 60.] The individual phases of the entrepreneurial process cannot always be clearly differentiated from each other. On the contrary, individual phases are interdependent and often overlapping [Stam/Garnsey (2005)].



C. K. Volkmann et al., *Entrepreneurship in a European Perspective*,
DOI 10.1007/978-3-8349-8752-5_2,

***Illustration 2-1:*** *Sketch of an entrepreneurial process*




**Conception and Gestation Phase**
The **conception and gestation phase** (organizational emergence prior to founding the enterprise) is characterized by the *recognition of an entrepreneurial opportunity,* the *development of a business idea, business plan development,* as well as a number of different *start-up or firm gestation activities* [e.g., seeking finance, hiring personnel, obtaining licences, registering with tax-authorities etc., as noted in Aldrich (1999).].

The recognition of the **entrepreneurial opportunity** is a complex and multi-layered process, which can be carried out in the form of an active and/or passive *screening and selection of the environment*. Entrepreneurial opportunities can, for instance, result from structural gaps between individual markets or from business transformations, such as the genesis of the internet economy. The entrepreneurial opportunity consists of a **business idea** and its potential realization. The business idea crystallizes into the **business plan**; a plan that represents the mental anticipation of the process of founding an enterprise and exploiting a commercial opportunity in the market place. The development of the business plan as an important part of the enterprise gestation process then evolves into specific start-up or gestation activities, which include concrete measures, such as the identification and acquisition of specific resources or necessary steps to establish a legal entity for the business. [For a discussion of the new enterprise formation process from the perspective of potential entrepreneurial capabilities involved in the process see Newbert (2005).]

**Starting-up**

Following a successful conception and gestation phase, the step of **founding the enterprise** entails the de facto *institutionalization of the enterprise* as it becomes an entity visible to others in the market place [Katz/Gartner (1988)]. In the process of creating a legal entity, the enterprise has to comply with numerous formalities. These formal requirements sometimes depend on the chosen legal form and may be the registration of business, entry into the Registry of Companies, or registering with tax or other authorities. In this phase, the initial *building-up of the organization including its boundaries* and the associated *combination of resources* take place. In this context, the first simple organizational structures, leadership styles and competences are defined and implemented.

**Viable Market Establishment of the Enterprise**

After founding the new business, establishing it in the market place is a primary task. During this phase of development, developing a sustainable position of the enterprise in the market in which it operates can be seen as the starting base for later growth. Depending on the personal attitudes and strategies of the founders, establishing the enterprise in the market in the first place can be seen as an *independent* part of the entrepreneurial process, which does not necessarily result in an intended growth progress [cf. Bhide (2000)]. When a specific enterprise size has been reached, founders often deliberately and exclusively decide in favour of keeping the enterprise stable as it is, i.e., they opt against growth. The reasons for this decision often lie in the desire to maintain a manageable enterprise size, which founders can still direct and control, or in keeping contacts with the staff personal and informal, which can be more easily achieved in small enterprises. The decision in favour of staying small or, alternatively, for an intended growth will be the individual decision of the founders. A lack of growth therefore is not necessarily a result of lack of entrepreneurial capabilities or resources in the entrepreneurs, as growth is often consciously avoided, especially in European enterprises. [See, for example, Jenkins/Johnson (1997) or Davidsson's study on the growth aspirations of business founders and owner managers (1991).]

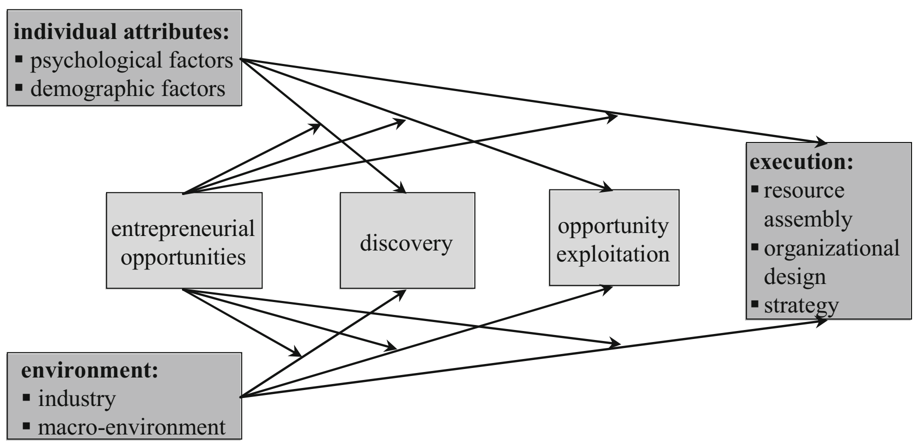
**Management of Growth**

The transition from the start-up to the growth phase is, as a rule, fluid and can therefore only be posited as a theoretical separation for a better understanding of the individual phases. The same applies to the individual phases of growth itself, i.e., *early development, (rapid) development* and *sustained growth.* In **early development,** the young enterprise must first strengthen the structures laid out at founding, and aim confidently at successful market establishment and, if planned, at further growth of the enterprise. As regards a purposeful management and control of young enterprises, it is in many cases recommended to create a *controlling system* already in the early development phases, which can be used for initial and further planning. Within early development stages, **growth** is decisively influenced by the strategic orientation and corresponding implementation of entrepreneurial strategies into business operations.

During the growth phase, core competences of the enterprise should be formed and developed, for managing rapid growth requires early-stage and frequent changes of structures and processes with regard to organization, leadership, information and communication. If necessary, new resources must be acquired and existing ones redistributed. The creation of an enterprise culture oriented towards growth can encourage an effective and sustained growth of the enterprise. Growth should not occur accidentally or by chance, but should be planned with purpose and confidence by the founders applying suitable growth strategies. [As indicated in Jenkins/Johnson (1997) and Bhide (2000), new enterprises often grow large even without initial entrepreneurial growth intentions of their founders. However, rapid growth of young enterprises must be managed both internally and externally in consonance with the external stakeholders of the enterprise.]

In addition to the concept discussed above, several other descriptions of the entrepreneurial process can be found in the entrepreneurship literature. One often cited model of the entrepreneurial process is the one according to Shane (2003) shown in Illustration 2-2

***Illustration 2-2:*** *Entrepreneurial process according to Shane*




The most striking idea within Shane's concept is the basic assumption of *(entrepreneurial)* **opportunities** and their discovery and exploitation. Individual attributes like psychological or demographic factors of the entrepreneur as well as the environment are interrelated with the concept of opportunities and lead to their execution. Execution essentially comprises the steps of resource assembly, organizational design and strategy. Note that the discovery of credible entrepreneurial opportunities and their exploitation is highly interrelated. This is essentially because opportunity involves the idea that it can be exploited or capitalized on (in the sense that something constitutes an *opportunity* to somebody only if he or she feels that it will be possible to assemble the necessary resources for its pursuit). I.e., within Shane's process the notion of opportunity is the key construct. [The concept of opportunities will be further discussed later on in chapter 2.1.2 and 2.2.1]

## 2.1.2 Individual Decision Process of the Founder

Many and diverse individual decision processes and actions can occur due to internal and external influencing factors, but they may also have their origin in the values and attitudes of the individual founder. To begin with, founding an enterprise is often a difficult decision for many people to take, even if they have an economically viable business idea with good market prospects. The changes and risks to one's personal life, i.e. the factors that cannot be assessed in advance, are often considered to be insurmountable. Conversely, there are people who see the challenges connected with the realization of a business idea as a freeing opportunity, and thus give up their secure workplace. Well-known examples of this attitude are Dietmar Hopp and Hasso Plattner as well as Klaus Tschira, Hans-Werner Hector and Claus Wellenreuther, the founders of SAP. At the beginning of the seventies, the founders handed in their notice at IBM, when their product idea of developing and marketing standardized software solutions met with the opposition of their superiors.

This example indicates that both the *recognition of entrepreneurial opportunities* which may not be perceived by others and the *establishment process of a new enterprise* are processes featuring a substantial degree of individuality and heterogeneity [Aldrich (1999); Shane (2003); also see chapter 2.2]. In the following section, the case of SAP and some other examples of new enterprises founded on the basis of a novel three-dimensional printing technology developed at the MIT will be considered.

**Case Study: SAP**
The enterprise *SAP*, formerly an abbreviation for System Analysis and Program Development, today "Systems, Applications, Products in Data Processing" was founded in 1972 by the five former IBM employees listed above as a civil corporation with their registered office in Weinheim and an additional office in Mannheim. At that time, the development of standard software represented a great challenge, and (because of their activity at IBM) the founders had recognized via conversations with clients that there was a market gap, which no software company had yet bridged.

Initially, mainly at night and weekends, the first software programs were developed by SAP. At the end of the first business year, SAP employed nine people with a turnover of 620,000 DM [approximately 317,000 Euros]. Two-and-a-half years later, the enterprise had already 40 reference customers, and in 1976, its reorganization into SAP GmbH Systeme took place. With 25 employees, the SAP GmbH Systeme achieved a turnover of 3.81 million DM [approximately 1.95 million Euros]. In 1977, the company's registered office was transferred from Weinheim to Walldorf, where it still is today. In the same year, the first overseas customers were acquired from Austria. In 1981, 200 customers used software from SAP, and the rapid growth of SAP continued. By 1982, approximately 250 enterprises in Germany, Austria and Switzerland used SAP software, and by 1986, the turnover mark of 100 million DM [approximately 51 million Euros] was exceeded. In the same year, SAP presented itself for the first time at the CeBIT information technology fair in Hannover.

In 1987, the process of internationalization began. The first national company outside the German-language area was founded in the Netherlands, followed in the same year by companies in France, Spain and Great Britain. The year also saw the development of the well-known R/3 systems. In 1988, the transformation from a GmbH (Limited Company) into an Aktiengesellschaft (joint stock company) took place. In October 1988, SAP went on the stock exchange and was first listed in Frankfurt and Stuttgart. The overseas business continued to develop positively. National subsidiaries were established in Denmark, Sweden, Italy and the USA, and the 940 SAP employees achieved a turnover of 245 million DM [approximately 125 million Euros]. Their thousandth customer, Dow Chemicals, was reported in the same year. By 1990, a turnover of 500 million DM [approximately 255 million Euros] was achieved with over 1,700 employees. In 1991, the first applications of the R/3 system were introduced with great success. Now employing 2,700 people, SAP achieved a turnover of 707.1 million DM [approximately 361 million Euros] with over 2,200 customers in 31 countries. In 1992, the R/3-system was introduced to selected pilot customers. The international expansion continued in 1993 with the introduction of a development centre in Foster City, California (USA), near Silicon Valley. In 1995, SAP started an intensified marketing effort aimed at small and medium-sized enterprises in Germany. In the same year, the SAP-share was included in the DAX 30 share index and its nearly 7,000 employees achieved a turnover of 2.7 billion DM [approximately 1.4 billion Euros].

In 1997, SAP celebrated their 25$^{th}$ anniversary. For the first time, their pre-tax profit of approximately 1.6 billion DM [approximately 818 million Euros] exceeded the billion DM threshold, with turnover reaching 6.02 billion DM [approximately 3.1 million Euros]. Their overseas share of the market was 81 percent with almost 13,000 employees. In 1998 SAP got listed on the New York Stock Exchange. With the launching of mySAP.com, a readjustment of the enterprise took place in 1999, as mySAP.com combined e-commerce solutions with the existing enterprise resource planning (ERP) applications based on web technologies. Over 20,000 employees reached a turnover of 5.1 billion Euros in the business year of 1999. In spite of the burst of the dot-com internet bubble, SAP was able to continue its steady growth. Approximately 24,000 employees in more than 50 countries achieved a turnover of 6.3 billion Euros in the business year of 2000. In 2001 SAP had a turnover of 7.3 billion Euros. From the technological point of view, SAP introduced the mySAP technology in 2001 and generated an architecture which allowed enterprises to integrate different IT systems. The growth continued further. By the end of 2002, the number of employees had reached approximately 29,000.

In 2003 Hasso Plattner, one of the founders of SAP, left the board of managers but was elected chairman of the board of directors to continue his creative influence on the enterprise. In the same year, SAP introduced the SAP-NetWeaver technology based on the mySAP technology, offering open, flexible and fast enterprise applications which allow continuous business processes irrespective of whether these systems originate from SAP or are based on the systems of other companies. The technological basis for the coming years was thus established. At the end of 2003, approximately 30,000 employees were working for SAP, of whom 27,000 were working outside Germany. At the end of 2004, over 24,000 customers in more than 120 countries were running about 84,000 installations of SAP software. In the business year of 2005, SAP achieved a turnover of 8.5 billion Euros, with subsidiaries in more than 50 countries employing nearly 36,000 employees. [In software development alone, a total of 10,600 people were employed worldwide by SAP.]

The company continued to grow in the period from 2006 to 2008. By 2008 SAP boosted its revenues to a total of 11.5 billion Euros and, at the end of 2008, employed more than 50,000 people. In the past, SAP has focussed on organic growth and continues to do so, banking on its research and development efforts (R&D expenses amounted to more than 1.6 billion Euros – i.e. approximately 14% of revenues – in 2008). Beyond organic growth, in 2008 SAP acquired the French software maker Business Objects, which was the firm's first major M&A transaction on its predominantly internal growth path. Like most enterprises, SAP has also been hit by the 2008-2009 global financial crisis, which forced the company to lay off personnel in its home country in 2009. However, SAP's global growth and development efforts continue. In addition to their main development centre at the head office in Walldorf, SAP is operating development laboratories in Palo Alto (USA), Tokyo (Japan), Bangalore (India) and Sophia Antipolis (France) as well as in Berlin, Karlsruhe and Saarbrücken (Germany) [SAP (2006)]. SAP also operates development labs in China, Canada, Israel, Australia, Japan, and a number of countries in Eastern Europe. Today, SAP is one of the most successful post-war enterprises founded in Germany. The vision of the five founders concerned the development of standard software for applications for real-time processing. They consistently turned their vision into reality and developed standard software by founding a small civil corporation, which led to the SAP enterprise of today. They recognized the entrepreneurial opportunity for standard software solutions, exploited it successfully and thereby built up a software enterprise which now operates globally and has achieved worldwide importance.

**Building different Start-up Enterprises on a single Invention – MIT 3-Dimensional Printing Technology**

"The three-dimensional printing process is a patented manufacturing technology invented in 1989 by four MIT faculty and doctoral students" [which] was available for commercialization through licence from the Technology Licensing Office (TLO) of MIT [Shane (2000), p. 453]. This technology allows building three-dimensional compounds based on binding powder material. Shane (2000) presents eight different start-up enterprises which have been founded based on licensing the 3D printing technology:

***Table 2-1:*** *Building different start-up enterprises based on a singular technology*

| Start-up Company | Entrepreneurial Opportunity |
|---|---|
| **Z Corp** | – manufactures a fast, inexpensive, office-compatible machine to make concept models for industrial and architectural design |
| **Therics** | – manufactures pills with a superior microstructure through a fully integrated manufacturing process |
| **Specific Surface** | – manufactures ceramic filters for the power generation market in a one-step manufacturing process |
| **Soligen** | – manufactures machines to make ceramic models for casting metal parts directly from a CAD model without wax forms or tooling |
| **3D Partners** | – creates a service bureau to produce architectural models from CAD writings |
| **3D Orthopedics** | – provides a service to create artificial bone for weight bearing indications to use in surgery |
| **3D Imaging** | – provides a service to create multi-color, three dimensional surgical models |
| **Conferences** | – establishes a chain of stores to make sculptures from photographs |

Table 2-1 [Shane (2000), p. 455] shows that a fairly broad range of different start-ups have been founded on the basis of 3D printing technology. The study goes on to discuss the "non-obviousness" (to others) of the different entrepreneurial opportunities and the role of prior (sector-specific) experience for perceiving these opportunities by the individual entrepreneurs; for example Shane (2000), p. 456 quotes one of the founders: "To make use of the 3D™ process for drug delivery, you had to know something about what drugs and drug delivery systems are made from and how drug manufacture operates." With regard to the process of exploiting these opportunities by establishing a new enterprise and entering a specific market, the case studies show that the perception of customer needs and the ways to tap and serve a specific market may also be linked to the founders' pre-existing knowledge about business and market characteristics. For example, in the case of Z Corp's concept models, it was the industry's demand for inexpensive and instantaneous on-site production of concept models which seemed obvious to the founders because of their prior work experience in industrial design and architecture (pp. 458, 459). Beyond recognizing initial business opportunities there is also a wide range of other possible factors which contribute to the decision on starting one's own enterprise and developing it over time (or deciding to abandon it) as highlighted for the examples of SAP and the above 3D printing based start-ups.

**Specific Factors of Influence**

Initially, the basis of entrepreneurial achievement, action and process is usually formed by the wish or the decision of one person to found an enterprise [i.e., the formation of entrepreneurial intentions to found one's own business; Krueger (2003)]. In simplified terms, the founder might carry out a specific **utility calculation,** which relates *chances and risks* (external assessment) to *strengths and weaknesses* (internal assessment) and weighs them up against each other. In particular, the founder's human capital in terms of one's competencies to start and run a business is considered to be important for the decision to become self-employed [Groysberg et al. (2007)]. However, the decision-process of a founder is not only influenced by internal and external business-related factors, but also by factors in the founder's private sphere, as becoming self-employed usually affects family life. In contrast to dependent employment, an entrepreneurial activity means at first an irregular income. In addition, the entrepreneur must be self-reliant in making provision for his or her old age. For these reasons, it is therefore necessary to include the family in the decision-process of becoming an entrepreneur.

With regard to the individual decision process, it is of crucial importance what motives cause people to found enterprises. The answer to this question is not only significant for one's own decision-process, but often also for other stakeholders of the enterprise, e.g., investors. In the field of entrepreneurship studies, motives of individuals engaging in entrepreneurial activity are often the subject of empirical research. For example, according to a field interview of full-time founders by the KfW Group of Banks (2005), the motives for founding an enterprise can be listed in the following order of frequency [cf. Kuratko et al. (1997) for a study with similar results for motives of continued entrepreneurship]:

- Creative freedom [79 percent]
- Own boss [72 percent]
- Free time allocation [59 percent]
- Higher income [56 percent]
- Lacking opportunities for further career development [43 percent]
- No present fixed employment [33 percent]

The **Global Entrepreneurship Monitor (GEM)** investigates whether a person founds an enterprise primarily on the basis of his/her perception of an entrepreneurial opportunity as **an opportunity entrepreneur** or because of an emergency situation as **a necessity entrepreneur.** The founders of SAP may probably be classified as opportunity entrepreneurs. Quite often people come to the conclusion, still to be proved empirically, that a business idea as the motive for founding a business generally will lead to a greater economic success than necessity entrepreneurship.

The example of Anita Roddick, founder of the natural-cosmetics chain "Body Shop", shows that start-ups which have arisen from an emergency situation can also be successful worldwide [see also Jenkins/Johnson (1997)]. Anita Roddick started the enterprise Body Shop in 1976 simply in order to make a living for herself and her two daughters. Before founding her enterprise Anita Roddick had no experience, education or training relating to entrepreneurship [Roddick (2001)]. In this context, it would be interesting to ask which decisive factors influence the decision process leading to new ventures to be founded and developed, yet there is no sufficient number of suitable empirical studies within the framework of entrepreneurship research available to date, which would allow a well-founded, comprehensive answer to this question. Our observations will therefore limit themselves to the three selected areas of *social, technical* and *cultural factors of influence.*

The socialization of the individual can be listed as one **social factor of influence** with its diverse variants, which in the relevant literature is often subdivided into two or three stages. In our context a differentiation between *primary* and *secondary socialization* will be made, although the dividing line between the individual stages cannot be drawn sharply. **Primary socialization** describes the (original) socialization of an individual in the family or through the parents of an individual. Here, an individual stable identity is formed in childhood as a basis with specific internalized norms, values and behaviours, which can, however, change within the framework of later secondary socialization. **Secondary socialization** refers to the socialization in family, nursery school, school and a circle of friends etc. Moreover, general adaptations of a person can be assigned to this stage, which are produced as interactions with his/her environment, e.g., in the form of a life-long learning process. In addition, secondary socialization can also refer to interactions and experiences in the everyday job routine with colleagues or superiors as well as other contexts of social community. A person's considerations with regard to a planned business start-up can be motivated or strengthened positively if, for instance, the parents or one parent has already been active as entrepreneur(s) and, among other things, taken on the function of a role-model. The opposite is, of course, also possible, that a negative image of an entrepreneur emerges, if the parents have not been particularly successful, in other words, if potential difficulties and problems are associated with their activity. So far it has not yet been researched sufficiently what concrete influence socialization really has on the decision process of a founder, so that no generalized statements can be made at this point [cf. the critical discussion of the work of David McClelland (1961) and his analysis of potential societal influence factors on entrepreneurial activity, as well as Hatten (1997)].

As **technical factors of influence**, which go beyond the socialization process, potential founders acquire in the course of their life the most diverse technical competences through educational processes in schools and universities as well as job experiences. This specialist knowledge can be seen as forming an individual's core competencies, with the existence of technical competences having a positive influence on the decision-process to become self-employed and form the basis for a target-oriented development of an enterprise [see, e.g., Linan (2008) for the relevance of competence-related entrepreneurial self-efficacy for the formation of entrepreneurial intentions]. Here, specific professional and industry-specific experiences can be beneficial. Another important point is a thorough business and management knowledge of the founder or, in the case of founder teams, of at least one team member. In addition to purely professional competences, other competences are certainly also required from a founder, which can influence the individual decision-process, such as innovation, leadership, and social competences.

**Cultural factors of influence**, which manifest themselves, for example, in the attitude of a society towards entrepreneurial thinking and acting, are also of great importance. In this context, the term **culture of entrepreneurship** is often used, although this term covers only a section of entrepreneurship. Not only the personal characteristics and entrepreneurial qualities of the entrepreneur are important but above all his norms, values and attitudes. Closely associated with these factors is also the image of the entrepreneur in society.

There are some, historically speaking important differences between the various social forms and states, which can encourage or hinder the evolution of an entrepreneurship culture. With regard to the USA, for example, we can generally assume a positive entrepreneurship culture exerting a positive influence on entrepreneurial activities. High gains derived from entrepreneurial activity are mostly considered as a positive by society, for gains in the individual wealth of each entrepreneur are expected to contribute to the process of **wealth creation** in general, thus increasing the wealth of society as a whole [see Timmons/Spinelli (2004) for this specifically US-American view on entrepreneurship]. This view is also held by the National Commission on Entrepreneurship in the USA:

> *Entrepreneurship is the critical force behind innovation and new wealth creation […]" [National Commission on Entrepreneurship (2001)]*

As a society can be shaped by different cultures, other points of view can be expressed. This is, for instance, the case when high profits from entrepreneurial activities are judged critically, as no benefit for society can be detected or is even non-existing. Furthermore, the attitude to business failure and granting a *"second chance"* within a society is important under cultural aspects. **Second chances** are opportunities which are given to entrepreneurs after the failure of their first entrepreneurial activity. Depending on the culture or society in question, second or any further chances in various forms are granted or refused. In order to establish an entrepreneurship culture, it is first of all important that any failure is *not* stigmatized as an incapability of the entrepreneur and that the latter is not spurned by society. An open entrepreneurship culture offers principally at least a second chance to failed entrepreneurs. This second chance can also be understood as a learning process.

Within this meaning the creation of an encouraging financing culture is important. For the small and smallest start-up projects, micro-credits (micro-lending) as financing devices can support the build-up of a positive credit history. For the development of an entrepreneurship culture it is vital that the failure of an enterprise be not regarded as a flaw, as the reasons for business failure are manifold [Pasanen (2005)]. This neutrality towards business failure is appropriate, in that blame cannot always necessarily be ascribed and attached to the entrepreneur as an individual. Second chances offer to the founder motivation and the latent security that he/she will not be stigmatized in case of failure. The granting of a second chance can therefore positively influence the individual decision-process of the founder person as well as the overall entrepreneurial process.

In conclusion, there are still no comprehensive empirical investigations available concerning the individual decision-process of a founder, so that the aspects and factors of influence we have dealt with so far cannot be taken as a complete representation. However, it is our intention to create an awareness of the problems and multi-layered complexity of the individual decision-processes of a founder.

## 2.2 From Entrepreneurial Opportunity to Business Idea

### 2.2.1 Entrepreneurial Opportunity

In free-enterprise oriented market economies there are numerous entrepreneurial chances or opportunities which must be discovered. This requires an *entrepreneurial alertness* for the recognition of chances [Kirzner (1979)]. However, not only their identification but also the exploitation of entrepreneurial chances is crucially important.

For example, following the 1949 currency reform in Germany, Werner Otto recognized the entrepreneurial opportunity of starting a mail-order business. With a starting capital of 6,000 DM he founded the Otto-Versand in a Hamburg barrack. With scissors and glue he created the first catalogue with fourteen pages. Behind each product he handwrote the price. In a next step, he hired a handful of employees, who produced 300 catalogues. At the time, a mail-order catalogue represented an innovative distribution form, which Werner Otto recognized and exploited resolutely [Handelsblatt (2005)]. Today, rotation machines produce 20 million catalogues with about 1,000 pages for Otto Versand. In addition, they publish approximately 60 special interest catalogues.

But the Otto-Versand business is not limited to the mail-order catalogue market, because the company also is the second largest Business-to-Customer (B2C) online retailer in the world. By 2008/2009, Otto-Versand had grown to a successful global trade and service company with an annual turnover of more than 10 billion Euros [Otto Group (2009)]. The example of Otto-Versand shows how the initial recognition and exploitation of an entrepreneurial opportunity can evolve into a multi-national company in practice. What is, however, the theoretical reference frame into which such practical examples can be integrated?

In Illustration 2-3 below the evolution of an entrepreneurial opportunity recognition process is sketched out [Shane/Venkataraman (2000), Ardichvili et al. (2003), Fueglistaller/Müller/Volery (2004)].

***Illustration 2-3:*** *Process of entrepreneurial opportunity recognition*

| **opportunity** → | **screening** → | **evaluation** → | **exploitation** |
|---|---|---|---|
| *existence of opportunities*<br>▪ economic unbalance<br>▪ asymmetric information | *recognition of opportunities*<br>▪ cognitive characteristics<br>▪ background knowledge | *essential factors of influence*<br>▪ characteristics of opportunities<br>▪ individual differences | *forms of exploitation*<br>▪ market solution<br>▪ institutional solution |

**The Process of Entrepreneurial Opportunity Recognition**

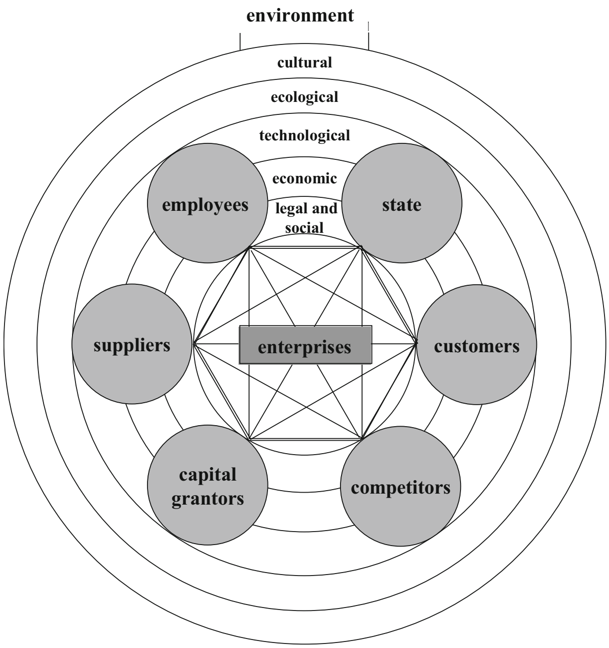
*Opportunity*

In contrast to neoclassical theory (which claims that a state of equilibrium in an economy produces entrepreneurial opportunities), it is now assumed that these arise from economic unbalance [Shane (2000); Koch/Grünhagen (2008)]. As an example, **arbitrage opportunities** can be utilized to achieve profits. [Arbitrage refers to time-limited trading opportunities, in which price differences for the same products in different markets are used with the aim of low-risk profit-making. Moreover, information is not distributed equally over the market. There is an **asymmetric information distribution** from which entrepreneurial opportunities arise [see Shane (2003), p. 161, and Casson (2003)]. For some players this will lead to a clear edge in knowledge which can be exploited in order to achieve profits [see Fueglistaller/Müller/Volery (2004)]. [For different fundamental theories of entrepreneurial opportunity recognition, also see Sarasvathy et al. (2003) and Alvarez (2005); further, some concepts of opportunity recognition reflect a passive discovery of opportunities while others refer to an active creation and “enactment” of opportunities by entrepreneurs; for this, see Alvarez (2005).]

*Recognition (screening)*
Theoretically speaking, the process of perception and exploitation of an entrepreneurial opportunity starts with screening [for example, see Fiet et al. (2004) for the decision to screen for entrepreneurial opportunities by serial entrepreneurs]. Screening in this context means the *scanning and selection of the environment (environmental scanning)* for potential entrepreneurial opportunities.

The **environment** consists of opportunities and risks, which the entrepreneur cannot normally influence, for any potential as well as existing enterprise interacts with the external environment. There are a number of possible categories of the external environment or *frame conditions: ecological, technological, economic, political, legal, social and cultural environment*. Market agents and stakeholders who are in a direct or indirect relationship to the enterprise act within these categories. Potential stakeholders are, for instance, *employees, suppliers, investors, competitors, customers, subcontractors, special interest groups (e.g., trade-unions)* or *the state.* [See also Illustration 2-4 based on Hungenberg (2004).]

***Illustration 2-4:*** *Differentiation of an entrepreneurial environment*



Continuous, slow and incremental developments are rare in a globalized world, with fast and dynamic changes prevailing in the everyday life of the entrepreneur as he or she faces the important challenge of anticipating what will happen in the future. Moreover, with regard to the environment, any changes, development tendencies and possibilities must be recognized as early as possible.

According to the foresight company *z punkt*, the following 20 megatrends shown in Table 2-2 might be of importance in the next years [z punkt (2008)]:

***Table 2-2:*** *Possible future megatrends*

| **Megatrends in the future** | |
|---|---|
| – Demographic change | – Globalisation 2.0 |
| – Individualisation reaches a new stage | – Knowledge-based economy |
| – Health thrives | – Business ecosystems |
| – Women on the rise | – Changes in the work world |
| – Cultural diversity | – New consumption patterns |
| – New patterns of mobility | – Energy and resource reversal |
| – Digital lifestyle | – Climate change and environmental impacts |
| – Bio mimicry (learning from nature) | – Urbanisation |
| – Ubiquitous intelligence | – New political world order |
| – Technology convergence | – Growing threats to international security |

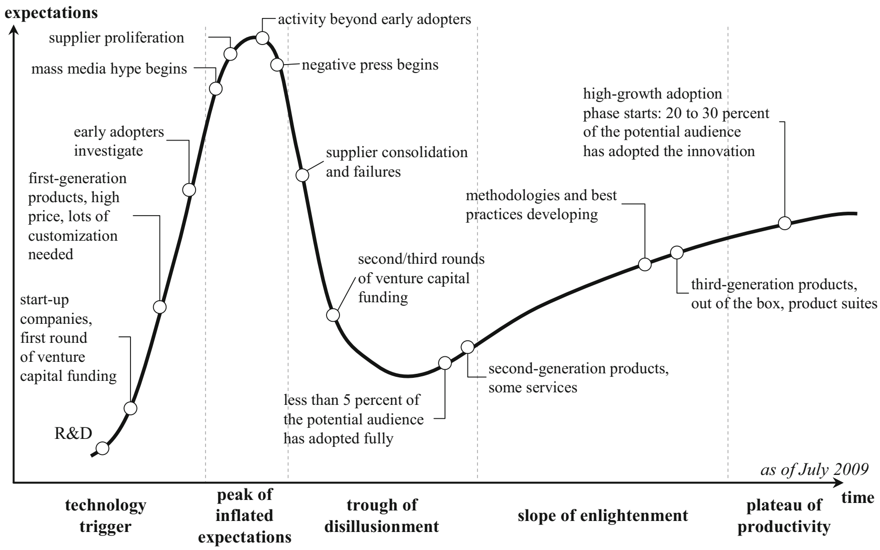
An impressive and comprehensible tool for assessing new technologies and their related hype and mainstream adoption time is the **hype cycle** according to the technology analyst company *Gartner* [www.gartner.com]. A hype cycle is a graphical representation of the maturity, adoption and business application of specific technologies. Since 1995, Gartner has used hype cycles to characterize the over-enthusiasm or "hype" and subsequent disappointment that typically happen with the introduction of new technologies. Hype Cycles also indicate how and when technologies move beyond the hype, offer practical benefits and become widely accepted [Gartner (2009a)]. Gartner introduced the idea of the Hype Cycle in 1995 as a commentary on the typical patterns of human response to technology. Since then, the use of Hype Cycles has expanded as a graphical way to track multiple technologies within an IT domain or technology portfolio. Gartner's Hype Cycle characterizes the typical progression of an emerging technology, from over-enthusiasm through a period of disillusionment to an eventual understanding of the technology's relevance and role in a market or domain. Each phase is characterized by distinct indicators of market, investment and adoption activities [Fenn/Raskino/Gammage (2009)].

The hype cycle consists of five phases that are characterized below [Gartner (2009a)]:

- **Technology trigger:** The first phase of a hype cycle is the "technology trigger" or breakthrough, product launch or other event that generates significant press and interest.
- **Peak of inflated expectations:** In the next phase, a frenzy of publicity typically generates over-enthusiasm and unrealistic expectations. There may be some successful applications of a technology, but there are typically more failures.
- **Trough of disillusionment:** Technologies enter the "trough of disillusionment" because they fail to meet expectations and quickly become unfashionable. Consequently, the press usually abandons the topic and the technology.
- **Slope of enlightenment:** Although the press may have stopped covering the technology, some businesses continue through the "slope of enlightenment" and experiment to understand the benefits and practical application of the technology.
- **Plateau of productivity:** A technology reaches the "plateau of productivity" as its benefits become widely demonstrated and accepted. The technology becomes increasingly stable and evolves in second and third generations. The final height of the plateau varies according to whether the technology is broadly applicable or benefits only a niche market.

Illustration 2-5 shows the theory of the hype cycle [Fenn/Raskino/Gammage (2009)].

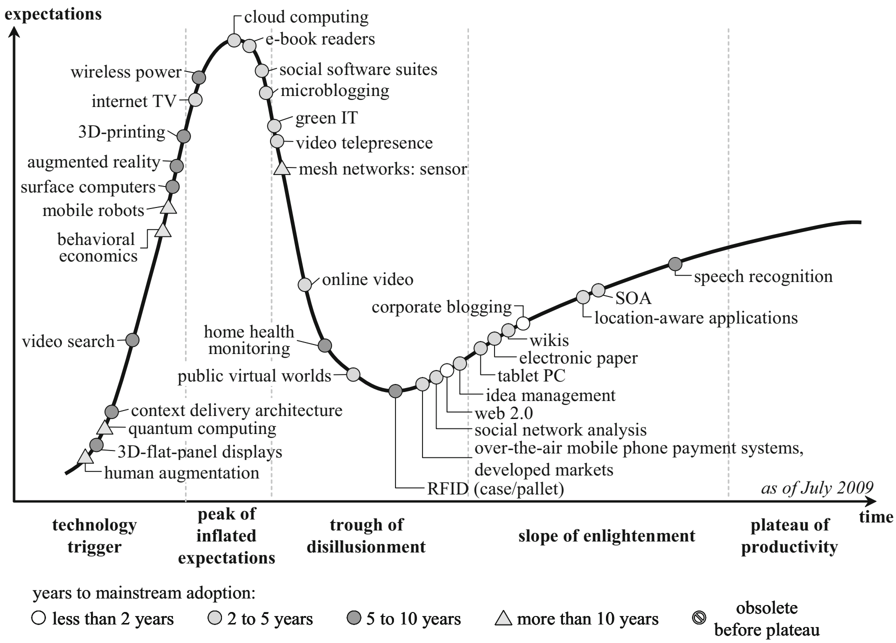
***Illustration 2-5:*** *Gartner´s hype cycle*



For a deeper understanding of terms like innovation, early adopters or venture capital, see chapters 2.3, 4.2.3 or 6.3.

Currently there are 79 single hype cycle reports available at Gartner. Each hype cycle provides a view on key technologies and trends in a specific technology, topic, geographic region or industry domain [Fenn/Raskino/Gammage (2009)]. Illustration 2-6 shows the *hype cycle 2009 for emerging technologies*, which is the longest-running annual hype cycle. It provides a cross-industry perspective on the technologies and trends that entrepreneurs (or managers) should consider in developing emerging technologies. The presented hype cycle features technologies that are the focus of attention in the IT industry because of particularly high levels of hype, or those that may not be broadly accepted but which Gartner believes have the potential for significant impact in the future [Gartner (2009)].

***Illustration 2-6:*** *Gartner´s hype cycle for emerging technologies*

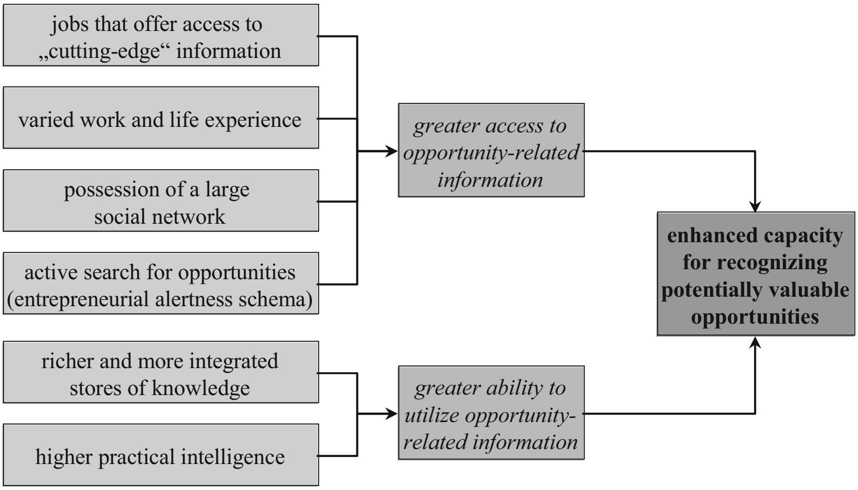



It has to be noted that other institutions might have a different view as to what will be (technological) megatrends in future decades. However, such differences are not important. What is important for an entrepreneur or enterprise itself is to deal with potential trends in the context of opportunity recognition. While anticipating future trends is not clear-cut, this uncertainty is exactly what constitutes potential opportunities for entrepreneurs. The exploitation of what may be profitable opportunities will by definition involve changing the commitment of resources that may be allocated alternatively elsewhere. But it is important for entrepreneurs to assess technologies, and (mega)trends in general, wisely because some trends may lead to inflated expectations regarding the business idea and it's developed business plans (as indicated in the above discussion of hype cycles). This is the other side of the coin of opportunities. And the market entry of start-up enterprises may be most risky at the peak of inflated expectations, in particular when kicking off with a substantial production capacity making the business model prone to disappointing levels of mainstream customer demand. [For the typical market shake-out that may occur when too many enterprises jump on the bandwagon of what turns out to be exaggerated initial prospects attributed to a new technology see Rovenpor (2004) discussing why so many internet start-ups failed.]

However, in the end all areas of the environment thus offer chances for the identification and exploitation of entrepreneurial opportunities as screening sectors. For screening and identifying opportunities, the individual **cognitive properties** of founders and their **specific background knowledge** are important [Shane (2000)]. Examples of specific background knowledge comprise *experience from school, education, training* or *occupation.* In addition, *background knowledge of a specific market, the supply of markets* or *existing customer problems can be important in the context of opportunity identification* [Ardichvili et al. (2003); Fueglistaller/Müller/Volery (2004)].

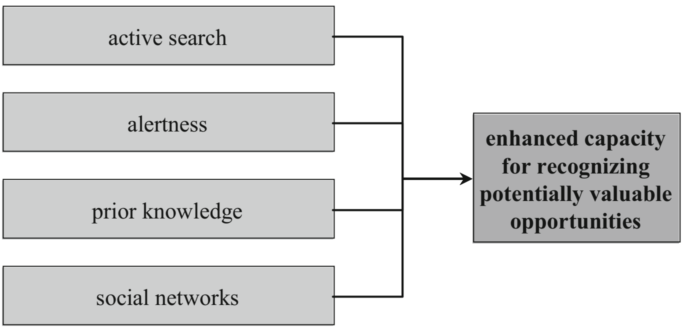
Conceptually, the role of different sources of information which can lead to a greater access to opportunity-related information or to a greater ability to utilize opportunity-related information is pivotal in this context. Both aspects reflect an enhanced capacity for recognizing potentially valuable opportunities. Illustration 2-7 shows this aspect. [See Baron/Shane (2008)]

***Illustration 2-7:*** *Opportunity recognition – the central role of information*




Important factors that may enhance the capacity for recognizing potentially valuable opportunities are shown in Illustration 2-8. [See Baron/Shane (2008)]

***Illustration 2-8:*** *Opportunity recognition – important factors*




Screening can be carried out by the entrepreneur as an *active* or *passive* process. The intended and purposeful cognitive perception, selection and evaluation of the environmental structure can be seen as an **active process.** This can be indicated by activities such as reading *technical journals and magazines, watching television programmes, trade fair visits or conversations* in professional or private everyday life which may lead to the detection of entrepreneurial opportunities. *Subconscious perceptions, selection and assessment of the environmental structure* as well as further-reaching impressions on our senses can be classified as the **passive process.** The differentiation between an active and a passive process is not clear-cut, however, as active or consciously perceived processes sometimes can also be influenced and controlled by unconscious mental processes.

This active or passive process of the assessment of the structure of the environment can be illustrated by a citation of John Chambers, Chairman and CEO of Cisco, who describes Cisco's strategy on the basis of market transitions [Chambers (2009)]:

> *"Cisco's strategy is based on catching market transitions—the market transitions that affect our customers. With the proliferation of video and collaborative Web 2.0 technologies, the network continues to evolve from the plumbing of the Internet—providing connectivity—to the platform that will change the way we work, live, play and learn."*

Whether a decision or perception is made actively or passively is primarily a psychological question which is not going to be dealt with in detail in this context. Irrespective of the classification as active or passive process, entrepreneurial opportunities are recognized by entrepreneurs, when they become aware of their environment and its associated challenges. Thus, they begin to look at the environment in terms of opportunities and chances. Entrepreneurs see solutions for existing problems and transform them into start-up projects (solution-centred approach), with these novel solutions ranging from merely incremental to truly revolutionary opportunities [Ganglio (2004)].

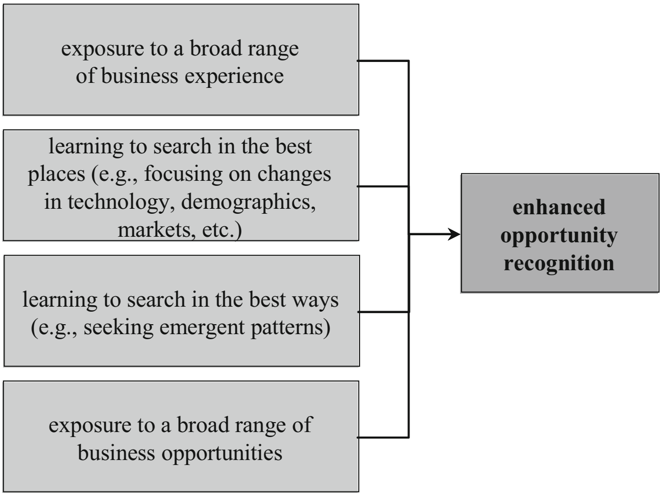
Note that there are differences between novice entrepreneurs and repeated (experienced) entrepreneurs with regard to opportunity recognition, evaluation, and exploitation. Table 2-3 sums up possible differences between these two types of entrepreneurs, which, for instance, differ in their perceptions and valuations. [See Baron/Shane (2008)]

***Table 2-3:*** *Novice entrepreneurs vs. repeated entrepreneurs*

| Novice Entrepreneurs | Repeated (experienced) Entrepreneurs |
|---|---|
| – How novel the idea is | – Solving a customer's problems |
| – Extent to which the idea is based on new technology | – Ability to generate positive cash-flow |
| – Superiority of product or service | – Speed of revenue generation |
| – Potential to change the industry | – Manageable risk |
| – Intuition or gut feeling | – Others in their network with whom to develop the venture |

Finally, the aspects of heterogeneous knowledge and information bases of different people which have been discussed in this chapter point to the idea that there may be specific sources of enhanced opportunity recognition. Illustration 2-9 shows possible drivers of enhanced opportunity recognition. [See Baron/Shane (2008)]

***Illustration 2-9:*** *Drivers of enhanced opportunity recognition*




*Evaluation*

During the recognition process, a first selection and evaluation of potential entrepreneurial opportunities already takes place in the screening process. In addition to this first (pre)-selection and evaluation, a systematic evaluation of the entrepreneurial opportunity (opportunities) can be carried out with regard to feasibility and potential profitability [Allen (2003)]. Similar to the above screening process, this evaluation can generally be made consciously or occur subconsciously. In this context, opportunity costs (i.e., unrealized profits from possible alternatives) are included into the considerations. Within the framework of evaluation, many criteria may be significant which influence the consideration of a credible (that is, both feasible and desirable) opportunity by the entrepreneur [Krueger (2003)]. The process of evaluation can thus lead to carrying out a feasibility study [see also chapter 2.2.2.3].

*Exploitation*
The exploitation of the entrepreneurial opportunity is the result of the preceding process-steps described. On the one hand, the enterprise can be founded by the person(s) who recognized the opportunity as such. On the other hand, it is also possible that the entrepreneurial opportunity is exploited via a selling decision, e.g., in the form of licensing knowledge or products to third parties. [In the latter case, it should be possible to protect it in order to avoid an easy imitation, e.g., through patenting.]

An example of the recognition and exploitation of an entrepreneurial opportunity is the rise of the sports wear manufacturer Airness [www.airness.fr]. The founder of Airness, Malamine Koné, who came from Mali to France at the age of ten, grew up in a suburb of Paris. Koné recognized that in the streets of his quarter, the young almost exclusively wore foreign brands of sports wear. Against the advice of friends, he decided to build up his own sports label, founding in 1999 Airness, with the aim of competing with established, internationally operating large-scale enterprises such as Adidas and Nike. The brand Airness, which has the logo of a crawling panther, very quickly won a large market share. In only six years, Koné managed to build up a successful enterprise in a difficult market, which is particularly remarkable against the background of dominance by Adidas and Nike. Koné has built up an enterprise, which currently equips several African national football teams like Congo, Mali, Guinea and Burkina Faso. Moreover, Airness is the outfitter of several French football teams like Lille, Nantes, Auxerre or Nancy. This proves that even in markets where established enterprises have a strong market presence, entrepreneurial opportunities can be found.

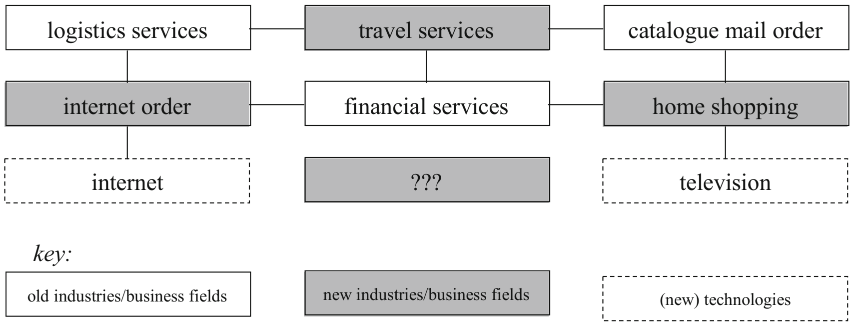
The identification and exploitation of an entrepreneurial opportunity as well as the generation and realization of a business idea are all part of an interdependent process. At the same time, it is often difficult to establish in individual cases whether the business idea or the recognition of an entrepreneurial opportunity came first. [For opportunity recognition see also Kirzner (1997); Shane (2000); Shane/Venkataraman (2000); Shane (2003).]

**Structural Gaps as Entrepreneurial Opportunity**
From a strategic management perspective, entrepreneurial opportunities can result from existing structural gaps or holes. Enterprises which are already in the market have established connections to each other via their respective market environment. They are embedded in network relationships reflecting specific value creation structures. Entrepreneurial opportunities may arise in the marginal areas of different business sectors, which have not yet been linked, or at intersections of business sectors. Covering a structural gap can mean the genesis or creation of a new and so far non-existing market. The exploitation of an entrepreneurial opportunity by starting a new venture, which closes a structural gap, is called a go-between-strategy. Theoretically, an entrepreneur recognizes a structural gap, decides in favour of a go-between-strategy and fills it by founding an enterprise [Lechner (2001); Lechner (2003)].

The concept of structural gaps was developed by Ronald S. Burt [Burt (1992)]. The explanation and systematization approach has been further developed and applied in different areas, as, for instance, by Hanson/Husted/Vestergaard (2005) in connection with science parks.

Using Otto-Versand as an example, Illustration 2-10 gives an overview of the go-between-strategy, filling a structural gap by founding a mail-order business.

***Illustration 2-10:*** *Structural gaps in the network approach*




Depending on the degree of scrutiny, structural gaps can be identified in different networks or areas of value-creating phases. Structural gaps can, for instance, arise or be identified within an existing industry or market, but also between different sectors. Examples of this strategy are low-cost airlines such as Southwest Airlines, Ryanair and EasyJet, which operate according to a "no-frills-concept" and have closed structural gaps within the "old" industry of the passenger air traffic. The concept of no-frills refers to an economic operation which is carried out according to the minimum principle associated with a strategy of cost leadership and a heavy reduction of costs within the limits of performance fulfilment. Together with substantial cost-cutting on board of the aircraft, additional measures are taken in order to ensure low costs, e.g., the use of one type of airplane or at least comparable airplane types. Furthermore, the ground times of the aircrafts as well as the administrative costs are minimized.

Generally speaking, there are fewer structural gaps in mature business sectors/industries with consequently fewer entrepreneurial opportunities. In conclusion, the concept of structural gaps offers a broad spectrum of possible applications to illustrate the perception and exploitation of entrepreneurial opportunities within the framework of the value creation chain of an enterprise and also between business sectors and markets.

**Industry Transformation as an Entrepreneurial Opportunity**
The greatest external (growth) chances for young enterprises are offered in particular by a revolutionary change of industry structures (industry transformations), such as, for instance, the genesis of the internet economy, bio-technology or nano-technology. According to Porter/Rivkin (2000), an industry **transformation** can be divided into the three phases of *triggering-off phase, insecurity phase* and *stability phase*. **Triggers** are *technological changes, changes in consumer behaviour and deregulations*, though individual triggers of change can also occur in combination. To pioneering entrepreneurs, these triggers offer *general* chances to exploit the transformation through the establishment and growth of new enterprises. In the trigger-off and insecurity phases, new business models are first introduced and tested with the aim of participating in the potential rapid growth of the changing industry [Porter/Rivkin (2000); Dowling/Drumm (2003); also cf. Aldrich (1999) for the phenomenon of industry evolution and change].

A retrospective view of the developments in the “dot-com” euphoria reveals that many business models were introduced, tested and then taken off the market, sometimes involving heavy financial losses [Rovenpor (2004); cf. generally Brouwer (2000) and Koch/Grünhagen (2008)]. The reasons can be found in diverse internal and external factors, such as, for example, lack of management competence and insufficient market potential. However, many very successful business models have prevailed in the market with strong growth or high growth potential, and have now achieved worldwide importance, e.g., Amazon, eBay and *Google*. These enterprises, too, were founded during an industry transformation cycle in the middle of the 1990s, although there may have been different firm-specific growth strategies that have strongly influenced the success of these enterprises.

## 2.2.2 Business Idea

### 2.2.2.1 The Concept of Business Ideas

A business idea is an initiating thought, which serves as the starting point for founding an enterprise. In most cases, a business idea contains conceptual problem solutions at the right time, in the right way and of the right type. Problem solutions can refer to products, processes, services and also customers. A business idea as a starting point for the establishment of an enterprise can occur by chance, as a result of purposeful search and development, the application of a technological development or because of customer problems and requirements, as, for instance, in the process of founding of SAP. The answer to the question where a business idea has its origin may not always be easy in individual cases.

Business ideas can be the result of product and service innovations or the imitation of existing products and services [cf. the entrepreneurial opportunity scale in Gaglio (2004)].

It may be assumed that in practice a business idea is seldom completely new, i.e., has never previously existed. Frequently, business ideas will be the result of incremental adjustments or imitations of existing products and services.

The transition between innovation and novelty and incremental adjustment and imitation is often fluid. For example, the question whether the development of the mobile phone represents an innovation or a further development of the telephone can easily lead to a discussion in which conflicting opinions are expressed. Not every business idea is transformed into a start-up. Potential founders often prefer an activity in a dependent employment because they are afraid of failure, or there is a lack of resources and networks which would allow successful opportunity exploitation by founding one's own business. It is also possible that the business idea is not feasible or commercially viable. In order to check the feasibility of business ideas it may be useful to seek professional help, for instance, the assistance of investors (e.g., business angels), professional consultancies or start-up agencies and institutions.

While in German-speaking countries, attention mainly centres on the development of business ideas, attention in English-speaking countries lies in the recognition and exploitation of entrepreneurial opportunities. The recognition and exploitation of an entrepreneurial opportunity through chance-events can be illustrated with the example of the US fast-food enterprise of McDonalds. Richard and Maurice McDonald were running a fast-food restaurant based on a simple entrepreneurial concept. The speciality of McDonalds was a specific, standardized product offer (hamburgers, fries and drinks). The essential success factors of the McDonalds' product offer consisted in fast preparation, standardization of quality and favourable prices. Together with friendly service, they produced a fast-food restaurant concept which enjoyed a strong demand. However, it was not the McDonald brothers who marketed their own concept into a world success, but Ray Kroc.

In 1954 a representative for milkshake machines, Ray Kroc, had only planned to sell milk-shake mixers to Richard and Maurice McDonald for their restaurant while touring the country. However, he was intrigued by the concept of their restaurant recognizing the potential as well as the entrepreneurial opportunity. He thus bought a licence from the brothers which would allow him to open restaurants based on the same principle. By taking out a licence and opening his first restaurant in 1955 in Des Plaines, California, he started expanding the concept from its local anchoring in San Bernardino, California (the original restaurant of the McDonalds') into the world. This example also demonstrates that an entrepreneur does not necessarily have to develop his/her own concept, product or service. The decisive factor for the global success of Ray Kroc was the recognition and exploitation of an entrepreneurial opportunity or chance, as the business idea as such had already been started by the McDonald brothers.

### 2.2.2.2 Development of a Business Idea

Different techniques can be employed for a systematic development, realization or further development of a business idea. Available individual and group creativity techniques are shown in Illustration 2-11.

***Illustration 2-11:*** *Creativity techniques*

| ***creativity techniques*** | | |
|---|---|---|
| *mapping techniques* | mind mapping<br>gallery method | creative clustering<br>moderation method |
| *association techniques* | brain storming<br>brain writing (6-3-5) | collective notebook |
| *systematic variation* | osborn check list<br>property list | morphologic analysis |
| *confrontation techniques* | image files | stimulus word analysis |
| *analogy techniques* | synectics | |

In principle, the techniques listed above are designed to help (in either a structured or rather unstructured free way) to support and to develop the creative potential of the planner. At this point, no detailed explanation of the above techniques is given but readers may refer to the following technical literature – some of which is on the popular-science level. Higgins/Wiese (1996); Nöllke (2004); Buzan/Buzan (2005); Vahs/Burmester (2005) have written on these techniques. [For more detailed information regarding the structured production of business ideas see, among others, Lüthje (2002).]

The most important questions in this context will possibly be the following:

- What chances does the recognized entrepreneurial opportunity offer?
- What customers can be acquired from the entrepreneurial opportunity?
- Which customer requirements can be met?

- Is there a concrete problem which must be solved?
- How can a problem be solved?
- Which normal and unorthodox methods can be used for the solution of the problem?
- Am I interested in the problem and how can I contribute to its solution?

### 2.2.2.3 Evaluation of a Business Idea

Following the development of a business idea, an **evaluation or assessment of the business idea** is to be carried out. At this point, it is above all important to ask whether there is an entrepreneurial opportunity for the exploitation of the business idea. A feasibility study can help to recognize whether a business idea has entrepreneurial potential before a formal business plan is elaborated and written and the enterprise is founded [See drawing up a business plan in chapter 3.1].

The evaluation of a business concept depends in particular on its degree of complexity. A simple idea which has already been introduced and proven in the market is supposedly easier to assess than a complex, innovative idea in the area of high technology. Generally speaking, the evaluation of a business idea with regard to the entrepreneurial potential or opportunity is a complex subject. Even if an analysis of the business idea is done, it is not possible to predict with complete certainty whether there is a corresponding future market or customer potential. It is, however, possible to make *subjective* but also (as far as possible) *objective statements* or *evaluations with regard to the marketability of the products and services on which the business idea is based.* Purely **subjective evaluations** assess a business idea exclusively on the basis of intuition, perhaps through conversation with friends, acquaintances or other people. In this case, the evaluation comes mainly from instinct. In contrast, one can try to make (as far as possible) **objective assessments** for the evaluation of a business idea. They could, for instance, be based on the results of a well-founded *situation and environment analysis*, which are important for the later exploitation of a specific business idea [cf. Delmar/Shane (2004b) for purposeful business planning for the market]. Within the framework of such an analysis, the *technological, economical, legal, cultural, ecological and social environment of the enterprise* and potential *employees, suppliers, investors, competitors and in particular customers* as well as the *state* might be relevant. Moreover, a market and competition analysis should be carried out, which helps to determine the *market potential, market volume* as well as the *potential market share.* [For a more detailed discussion of environmental and competitor analysis see also chapter 4.2.1; for a discussion of feasibility analyses of business concepts also cf. Allen (2003).]

In this context, the following questions can help to contribute to a solution:

- What is the concrete function of the planned product or service from the perspective of future customers?

- How competitive is the product or service as compared with the offers of competitors?
- Is it a new product or process technology?
- How far developed/matured is the technology?
- Who are the potential customers?
- Are there relevant legal restrictions for the production or distribution of the product?

It is essential to gather and analyse information concerning, for instance, the potential (target) market, the customers, possible direct competitors, and substitute products as well as the characteristics of the underlying technologies to be used (e.g., for production). The systematic collection of the relevant information and the evaluation of a business idea sometimes require a lot of *time, know-how* and *capital.* Moreover, there is also the challenge to evaluate the collected data and assessments as objectively as possible. However, subjective influencing factors cannot be excluded altogether in an evaluation. The knowledge gathered within the competition and environment analysis can be used later in drawing up the business plan, if a positive decision for the realization of a business idea has been reached [Allen (2003)].

In any case, it should be possible for the founders to explain a business idea in a few sentences and present it concisely, so that it can be easily understood by third parties as a prelude to testing.

#### 2.2.2.4 Presentation of a Business Idea

The presentation of the business idea can be done in various forms. It is important to decide when and where the business idea is to be presented and who forms the target group. In principle, setting up a business plan or the finished business plan itself can be understood as the framework for presenting the business idea.

Ideally, it should be possible to explain the business idea in three minutes at the most to a third party without a specific knowledge and know-how. The business idea should be described as simply as possible in a convincing story line [Loansbury/Glynn (2001)]. In three minutes, it must be possible to inform and convince the third party of the usefulness of the business idea. This approach is called the **elevator pitch,** i.e. a *virtual elevator ride* with a short connection period between the founder and a potential investor is assumed. Using their brief and concise presentation of the business idea within the assumed three-minute elevator ride, the founders aim to induce a potential investor to give the venture project more thought. In general, the time of potential investors for considering specific business ideas is limited. Founders need to win the attention of potential investors, and should they be successful, it is recommended to use these chances very quickly and very effectively, as many founders are in constant competition with each other. It is therefore of crucial importance to communicate information or core messages purposefully and efficiently in a fast and simple way.

For a successful presentation, the choice of a straight-forward, precise and comprehensible language is essential. The founders should not use a specific and too technical language, or even abbreviations. [Engineers and scientists in particular sometimes tend to focus on too many professional and technical details of the business idea, which are incomprehensible to laymen.] The language should be principally adapted to the individual target group, so that the business idea can be understood. In doing so, it is advantageous to take the presentation to a linguistically simpler level, with technical aspects and solutions not being understood as an end-in-themselves but in relationship to their usefulness to the customer.

Technology is to be seen as an instrument for the realization of a business idea which puts customers, their needs and useful benefits into the centre. After all, the possible success of a business idea lies in its economic feasibility which should be communicated to potential investors and other stakeholders in a comprehensible manner. In essence, it will be task of the founder to communicate an entrepreneurial vision and tell a convincing story around his/her start-up project. This is precisely because start-up business concepts lack a track record of past performance and "proof of concept" [Aldrich (1999); Downing (2005)]. In this context, some questions can help to prepare a convincing presentation of a business idea:

- What is the nucleus of the business idea?
- How can this core element be conveyed in a convincing way?
- Which aspects and areas are of crucial importance in a short presentation?
- Is the business idea comprehensible?
- Has one paid attention to the choice of a simple, concise and comprehensible language?
- To whom can the presentation be submitted for a first test and for improvement?

These and many other questions are designed to help structuring and drawing up good presentations specifically directed towards different target groups of business concepts.

### 2.2.2.5 The Business Idea and Industrial Property Rights

The development of technological knowledge and know-how is an important device for young enterprises, as it can lead to a clear edge over competitors and gives the enterprise a *unique selling proposition* in the process of converting the business idea into marketable products. Contrarily, the lack of unique products or technology know-how can be a knock-out criterion for equity investors because of the threats of direct price competition when no competitive advantage can be generated [e.g., for the case of venture-capital investors see Manigart et al. (1997)]. Sources of competitive advantage serve to secure the existence of the enterprise and to contribute to the generation of future growth. In particular, for young enterprises it will not be possible to generate advantages over established firms based on their size (e.g., economies of scale) or brand power. However, a strategy of competing on competences based on innovative product elements, novel technology, and specific know-how may be important to young enterprises. [For such a competence-based view on business strategy see, e.g., Sanchez et al. (1996).] However, for this it is not sufficient just to develop technology and innovative products. In addition, strategies must be employed which secure this advantage in technology and knowledge against other enterprises over time because of the threat of imitators and substitute products. "When you develop a new product, you create an asset that must be protected. If you have developed a unique device, a unique process or service, or another type of proprietary item, you may qualify to apply for intellectual property rights under the law" [Allen (2003), p. 144)]. An important task for innovative entrepreneurs is therefore to develop and employ a **protection strategy through utility or design patents** which protect innovative product functions and designs; entrepreneurs should also seek **protection of trademarks** as an element of their brand-building efforts.

Patents and registered designs are indispensable tools with which to safeguard intellectual resources built up by young enterprises through achievements in research and development. The area of patent law and intellectual property rights is a complex and multi-layered subject, so that at this point we can only point at its role to entrepreneurial business strategy to help securing unique resources and assets and building sustainable competitive advantages. Thus we forgo a practical discussion of the patent application and granting process, as well as the relevant laws and regulations which differ substantially across countries. [For an introduction to European Patent Law see Dybdahl (2004).] Also note that although patentability information and patent filing procedures are documented in patent law and other official sources (e.g., the websites of patent offices), founders and inventors may even so benefit from the counsel of specialist industrial property agents [Allen (2003)].

**Trade Secrets**

In addition to the decision to give notice of a patent, there also is the possibility of treating an invention simply as a **trade secret**. In this case, no monopoly position or protection of investments is achieved, and on the other hand, no patent is published so that the invention can only be used by the inventor himself. If this method is used it should not be possible to easily copy the technical product by *reverse engineering,* or to derive a secret technical procedure.

This situation, however, is connected with the risk that trade secrets could be passed on by employees to outsiders. Care should therefore be taken that a positive enterprise culture is established which minimizes this risk. In addition, legal measures such as contractual and post-contractual secret clauses should be used to reduce the potential damage. Giving away trade secrets can be very critical, in particular for young enterprises, as the trade secret constitutes an essential component of the enterprise concept. There is also a risk that the trade secret will be filed as a patent by those employees of the young enterprise who seek to cash in on their knowledge, or by third parties if they have betrayed the secret. If this occurs, according to German law at least, the use of the trade secret in existing parts of the enterprise can continue within the meaning of prior-use right. However, in some cases, the export of the product or process to other countries in which the patent has been filed by third parties can be prohibited. In such cases, compensation claims may arise. As a countermeasure in the case of a betrayal of trade secrets, which in principle are patentable, it may be advisable to publish the trade secret with the consequence that the trade secret becomes part of the current state of technical development and is no longer new. Therefore the invention (trade secret) can no longer be filed as a patent, as the aspect of novelty has been lost. As regards "publication" it suffices if it addresses only a limited audience, e.g., as part of a presentation at a trade-fair.

The strategy of treating something as a trade secret cannot necessarily be described as disadvantageous. The individual advantages and disadvantages should be weighed up against the background of the specific situation of a young enterprise. Apart from that, trade secrets can basically be seen as advantageous if the invention is not patentable at all because of the regulations of the individual patent laws. This is, for instance, the case with recipes. Recipes in the gastronomy or food sector, which represent a unique selling proposition for a young enterprise, cannot be patented for their protection. The only possible strategy here consists in keeping the recipe a secret. In the same way, the general patenting of a business idea is not possible. In order to safeguard a business idea, concrete technical inventions can be patented on the one hand, which are designed to form the core of the business idea as well as to supply a competitive edge. On the other hand, a specific combination of resources in individual sectors and types of strategies in the young enterprise should ensure that a competitive advantage and a safeguard of the enterprise as well as growth can be realized. In this context, the mutual dependence and coherence of individual strategy types, tools and approaches can again be illustrated. A strategy for securing knowledge and know-how can contribute to the security of products and processes. However, this choice of strategy alone is no guarantee of the entrepreneurial success. It is only one element of interdependent enterprise and growth strategies. In summary, it is important to follow a holistic approach or to apply a holistic perspective.

## 2.3 Innovation

There is a close connection between entrepreneurship and innovation. Peter F. Drucker even considers the area of innovation as a specific tool of entrepreneurship:

> *"Innovation is the specific instrument of entrepreneurship. It is the act that endows resources with a new capacity to create wealth. Innovation, indeed, creates a resource." [Drucker (2004), p. 27]*

Following the above quotation, innovations can *create wealth* within the context of entrepreneurship. New resource combinations are generated and, in a wider sense, entrepreneurs take on a social responsibility by creating wealth.

### 2.3.1 Invention, Innovation and Imitation

**Invention**
The term *innovation* must be demarcated from the concepts of *invention* and *imitation.* **Invention** is generally understood as the *discovery of a novel technical realization of a problem solution.* Often creative processes or spontaneous ideas form the basis of generating inventions. Possible inventions as a preliminary step to a marketable innovation make new and useful applications possible. Inventions can develop in a planned or unplanned way. Planned inventions require a systematic, target-oriented approach, while unplanned inventions can happen by accident. Whether or not inventions had been planned can, however, not be taken as a measure of their quality. There are numerous key inventions which were produced by accident and therefore unplanned. Often inventions are qualified as accidental, which in reality were the result of conscious or unconscious occupation with the subject. The widespread view that Thomas Edison got the idea of the light-bulb as a spontaneous idea over night does not reflect the facts. Edison's laboratory books show that he had worked systematically on the innovation of the light bulb, as he himself was not the inventor of the light bulb. Based on an already existing invention he further-developed and improved the light bulb until it was marketable [cf. Hargadon/Douglas (2001); also cf. Carlson (2003) for the case of Edison's sketches of the telephone].

Inventions require an intensive occupation with the subject and yet also a certain distance to allow new solutions to enter the field of vision. They cannot be produced on command but often need some time to mature. In this context, the speed with which new products are invented and reach market maturity is often overestimated, especially by young entrepreneurs. According to a study of 650 manufacturing enterprises worldwide by Deloitte & Touche (2004), the average product development and introduction period from the first concept idea to the introduction into the market in 2004 was 15.5 months. In this study, the introduction of new products and services is seen as a central factor for the enterprise growth during the period of 2004-2007 in the respective individual lines of business. The investigated business sectors were automotive, consumer goods, manufacturing (make-to-order production), high technology, telecommunication, life sciences, "process industry" and chemicals. Up to 2007, the turnover share of new products, which had been introduced during the three preceding years, was targeted as 34 percent. This was an ambitious aim, as the turnover share in 1998 had been 21 percent. In order to reach this target, only 12.8 months were allowed as the average product development and introduction period for 2007. This pressure, which is mainly exerted by established or larger enterprises, will probably also have an effect on young enterprises. The area of innovation is becoming more and more important, which also requires basic inventions and fundamental new technologies whose development to market maturity can take a long time. The example of the invention of the charge-coupled-device (CCD) technology shows how long it can take until inventions reach the stage of products with mass-market suitability.

Charge-coupled-device technology, which transforms light patterns into usable digital information, forms the basis for modern imaging procedures. The current effect which can be recognized on the market is the employment of this technology, for instance, in digital cameras, video cameras, bar code readers as well as scanners and photocopiers. The technology was developed in the Bell Labs in 1969 by two scientists, Willard Boyle and George Smith. In 1970, they employed the CCD technology for the first time in a video camera, followed in 1975 with a demonstration of the first CCD camera with a picture quality that was good enough to be employed in television production. In 1983, telescopes were equipped with CCD cameras for the first time, which allowed astronomers to study objects a thousand times smaller than those which could be seen with the existing, ultra-sensitive photographic plates. Moreover, employing this technology allowed the scientists to look at the images they had taken within seconds, something that would still take hours today without this technology. Currently, digital information systems based on CCD technology are also employed inside the Hubble space telescope.

Since its invention, CCD has produced significant new industries and markets with a large variety of products. These markets and products include digital cameras, camcorders, security monitoring systems, medical endoscopy equipment as well as video conference systems and modern systems which can be employed in astronomy. In addition, the knowledge which backs CCD technology has played a decisive role in the generation of optical networks which today form the basic transport technology for the internet and other core areas of communication networks.

> *"The CCD is one of those crucial breakthroughs that lead to innovations in sometimes unexpected areas. In fact, Bell Labs continues this legacy of innovation today and currently has research that builds on Boyle and Smith's breakthroughs in areas as diverse as nanotechnology and advanced photonics for applications in communications, next generation computing, and homeland defence." [Rod Alferness, Senior Vice President for Research and Development at the Bell Labs]*

This example of the spread of CCD technology illustrates the broad spectrum of influence which a single invention can have over the years. However, it also clearly shows how long it can take until high-quality technologies can be employed and become profitable for the improvement of mass-production products.

**Innovation**

Ideas, inventions or prototypes are not innovations yet but only important steps on the route towards an innovation. What does the concept of innovation actually mean? Generally speaking, the innovation concept is used in a large variety of forms and in diverse contexts. Etymologically, the word is derived from the Latin concept of novus = new, and innovatio = something newly created. In economics, the concept **innovation** can be defined as *a novel problem solution of a technical, economic, organizational or social type,* which is realized *in enterprises* or *in the market.* Innovations can be new products, processes, organizational or social innovations in organizations or related directly to the market place. The transformation *of an invention into a (marketable) product* is an innovation. Schumpeter already had a comprehensive understanding of the concept; according to him innovation is "the creative destruction of the existing by an entrepreneur". The destruction is to be seen as the devaluation of still technically functioning products or services which accompanies the introduction of innovative products or production processes. Moreover, in a market economy, destruction also challenges market structures or competitive positions "stuck in a rut". This aspect of destruction has a high significance in market economies, as it is designed to achieve an optimum resource allocation and competition. Destruction is achieved through new products or new qualities of a product, new production methods, the opening-up of new distribution markets, new organizational forms or new forms of procurement [see Schumpeter (1934)].

Very often, concrete customer problems are recognized but technical or innovative opportunities for their solution are still lacking. An example for an innovative problem solution in the area of genetic technology is the first breeding of hypo-allergenic cats in the USA. The initial problem is that cats normally produce a protein to which some people react with an allergy. For these people it is barely possible to keep a cat as a pet. The North-American enterprise *Allerca* [www.allerca.com] claims to have solved this problem. According to their own statements, their scientists have succeeded in producing the first hypo-allergenic cats. These genetically modified cats supposedly no longer cause allergic reactions in humans and were made available to customers by Allerca since 2006. Although the problem of an allergic reaction in humans to cat proteins had already existed for some time, and the triggers were at least partially known, only the use of innovative processes in the gene technology and of bio-informatics allowed a solution to this problem.

**Imitation**
Innovations form the basis of later imitations in particular when innovations have been successfully introduced and proven in the market. The concept of **imitation** describes the copying and therefore the repeated application of an existing problem solution, product, service or process. With regard to time, the imitation follows the innovation. In the case of a market success, innovations are often copied by imitators who themselves offer the imitation in the market; this strategy is useful, bearing in mind that imitation is cost-efficient, avoiding the technology, production and market risks of earlier first movers [Aldrich/Martinez (2003)]. Especially innovative services, for which there are few protection rights (for instance, in the form of patents), can be quickly copied and marketed by competitors. The question when a product or a service is an innovation or an imitation is not answered clearly and uniformly in the relevant literature. Occasionally, the term "innovative imitation" is also used, in which an enterprise conquers, for example, a new market innovatively. This is an imitation in so far as the product or the process is not fundamentally new. According to this concept interpretation, *Red Bull* would be an innovative imitation as a "cult drink". It would be innovative, as the enterprise has introduced the high-caffeine-drink into Europe. The aspect of imitation has its origin in the fact that the product had existed previously in Japan under another name where it was also marketed successfully.

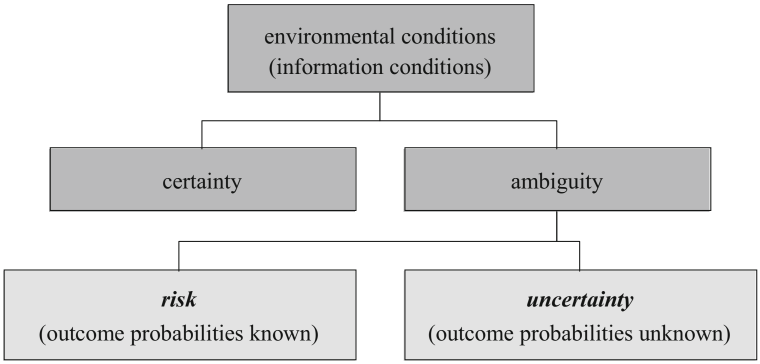
## 2.3.2 Innovation and the Innovation Process

Innovations can be characterized by typical features, including novelty, uncertainty and risk, complexity, realization of the innovation, as well as conflict and resistance in the market. It is generally accepted that an innovation must be something new, with the *degree of novelty* being important either for *the enterprise itself* or *for the market*. Innovations are also associated with uncertainties and risks, especially with regard to their future market success.

One important challenge to management is the fundamental *ambiguity* of what will happen in the future, in particular because of the dynamism and complexity of the strategic environment of new enterprises. This lack of clarity as to what outcomes entrepreneurial action will have and what action may be best can take to different forms: **risk** and **uncertainty**.

According to Knight, uncertainty describes a condition under which an expected profit or future value cannot be calculated, as it is not possible to predict all possible future states of the world and attach outcome probabilities to them [Gifford (2003)]. Therefore, an *infinite* number of states is assumed. In contrast, risk describes a condition in which the market agents can calculate an expected profit, as in this case a *finite* number of possible future states is assumed and respective probabilities can be assigned to them. Thus, risk can be seen as a "measurable uncertainty". Illustration 2-12 shows a systematisation of risk and uncertainty.

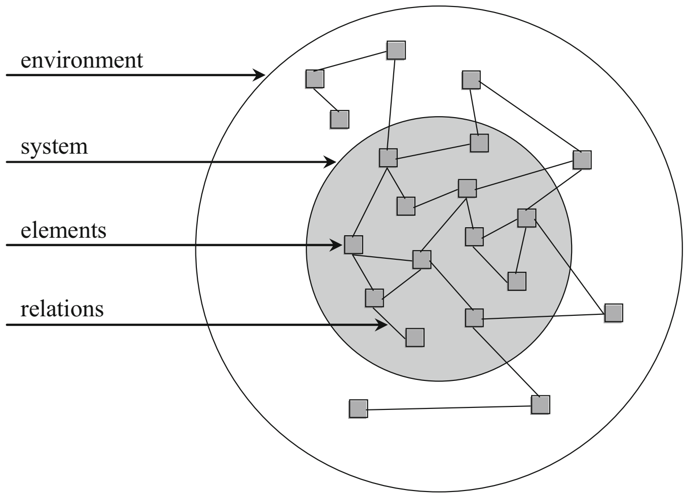
*Illustration 2-12:* Risk and uncertainty




When assessing a risk, influencing factors within and outside the enterprise must be evaluated against specific criteria. In practice, the risks of innovations are estimated using diverse methods, such as the generation of different scenarios (scenario analysis).

**Complexity** can be determined by means of the type and number of different elements inside and outside a system, their interdependent relationships and their own, often *non-linear, dynamics*. Illustration 2-13 gives an overview to a systems approach [according to Hugentobler/Schaufelbühl/Blatter (2008)]. As often all areas of an enterprise are directly or indirectly involved in the innovation process, the result is a high degree of complexity. Any decisions which have been taken cannot be withdrawn from without time, finance or personnel expenditure, as the individual processes and organization members are interconnected. A high complexity of the innovation makes high demands on the innovators themselves, but also hinders the possibility of imitation. The complexity and time intensity of innovation processes are *often underestimated, especially by young enterprises*.

***Illustration 2-13:*** *Systems approach*




Another characteristic feature of a successful innovation is its **realization** in the market place and its acceptance by target customers, who value the new product or service offered. In other words, innovations meet a specific need and demand by consumers and businesses [Spielkamp/Volkmann (2005)]. **Conflicts** may arise because of the numerous obstacles and risks which go hand in hand with innovations. The introduction of innovations is, for instance, associated with many **resistances** and **mis-estimations** within the enterprise but also with regard to the market. [See, for example, Aldrich/Fiol (1994) or Hargadon/Douglas (2001) for the characteristic difficulties faced by pioneering entrepreneurs to establish innovations in the market because of the uncertainties surrounding them.] The following quotations are meant to illustrate this problem area:

> *"Who the hell wants to hear actors talk?"*
> *[Warner 1927]*

> *"There is no reason for any individual to have a computer in their home."*
> *[Ken Olsen, President Digital Equipment Corp., 1977]*

> *"I think that there is a world market for perhaps five computers."*
> *[Watson, Chairman of IBM, 1943]*

> *"The telephone has too many defects to be seriously considered as a means of communication."*
> *[Western Union, 1876]*

Often different interests are contradictory to each other and require a solution. However, conflicts as such are not necessarily negative, for positive conflicts often contribute to communication, new thinking, and thus possibly a solution. With regard to innovations, discussions about potential problem areas can open up possibilities for a solution.

**Types of Innovations**

When referring to the characteristic features of innovations, different **types of innovations** are generally distinguished in theory and practice. [See, for example, the comprehensive literature review in Garcia/Calantone (2002) who address various aspects of defining and measuring innovation.] Depending on the understanding of the concept of innovation employed, these can be differentiated in a narrower or wider sense. In the narrower sense, one distinguishes between product and process innovations. If the concept of innovation is interpreted more comprehensively, innovations refer not only in a technical-functional sense to products and processes, but additionally to economic, organizational and social aspects. In the case of **product innovations,** we deal with new or significantly improved products and services with which an enterprise aims at specific target markets. In particular for young enterprises, new products and major further developments of existing ones are a critical factor for success. It is true that often young enterprises have only one core product at their disposal which offers a short-term growth potential, but in the long-term it must be complemented with other products in order so safeguard the existence of the enterprise and allow further growth. **Process innovations** are new or significantly improved manufacturing or process-techniques or methods of providing services. They are mostly directed towards an improvement of the performance of an enterprise, e.g., through increases in productivity or efficiency. Improvements can refer to material- or information-related processes. Individual target areas are, for instance, cost-reduction, decrease of through-put times, reduction of employed production factors but also quality increases. The finance, personnel and time resources of young enterprises are usually limited and not available on a large scale. These enterprises therefore often focus on product innovations. Frequently, this means that process and operational innovations (and thus internal operational efficiencies) are often neglected. Scope for cost reductions is not recognized and remains unexploited.

On a broader scale, **social innovations** are often associated with changes in the interaction and communication of people within an enterprise or organization. For instance, social innovations may aim at a higher level of job-satisfaction or improving working conditions. In this way social innovations, especially in young enterprises, can have a significant effect on the internal acceptance and the success of innovation processes. In an ideal case, creativity could, for instance, be encouraged, communication might be improved and the commitment of employees to the enterprise could be strengthened. **Structural innovations** are often assigned to social innovations in the relevant literature. They include organizational changes within enterprises which may be brought changes brought about by innovative improvements of organizational structures and procedures. During the growth process of a young enterprise in particular, critical periods or junctures can occur in which structural innovations may offer a suitable solution.

Social and structural innovations are closely connected to process innovations and the three are in fact interdependent. If the concept of innovation is interpreted in a very wide sense, it must, however, be noted that not every change in enterprises and other organizations is a social innovation, and that structural changes within an organization are not necessarily a structural innovation either.

An important aspect of innovation is novelty. Assessed against the criterion of the **innovation degree** we may deal with an *evolutionary* (incremental) and *revolutionary* (radical) *innovation*. [See the entrepreneurial opportunity scale in Ganglio (2004) again which classifies opportunities, which are often related to innovations, in a similar way according to their degree of newness; see Garcia/Calantone (2002) for a thorough overview of measuring various aspects of innovation (e.g., the type of innovation or degree of newness).] **Evolutionary innovations** have a lesser degree of innovation, for they are based on existing innovations and represent incremental improvements and extensions of existing products, processes and social structures. Evolutionary innovations are also called improvement or successor innovations. They are obtained through a continuous improvement or evolution over a period of time. In contrast, **revolutionary innovations** occur discontinuously in a mostly unstructured fashion with epoch-making, radical consequences with regard to products and processes. For this reason, revolutionary innovations are also called radical, pioneering, basic or also break-through-innovations [Hauschild (2004)]. The basis of revolutionary innovations is formed by inventions which are then transformed into marketable products.

The vacuum cleaner Dual Cyclon is considered to be a good example for a revolutionary innovation, as it vacuums without a vacuum bag using a new technology. The invention and marketing of this vacuum cleaner set new standards and defined new markets. With the slogan "never buy a bag again", James Dyson, the inventor of the bag-less vacuum cleaner, started in England and has in the meantime conquered significant shares of the European market.

In addition, innovations can be classified into *technology-induced* or *demand-induced innovations*. **Technology-induced innovations** (technology push) are kick-started and facilitated by technological developments within and outside the enterprise. The findings of fundamental research form the basis of technology-induced innovations. From the point of view of business management, the decisive factor for technology-oriented innovations is their successful exploitation in the market. With regard to technology types, we can distinguish between *sustaining technologies* and *disruptive technologies.* **Sustaining technologies** are maintaining or complementing technologies, which do not trigger off a replacement effect on existing technologies. Rather, an improvement of existing product-market structures will occur. This type of technology is usually introduced by established enterprises. **Disruptive technologies** can be described as destroying or replacing technologies. They require the establishment of new product-market structures. The innovation potential and innovation structure of young enterprises encourage the introduction of disruptive technologies through entrepreneurial start-up activity. Very often, new enterprises arise as spin-offs from universities, industrial companies or research institutes. Spin-off enterprises develop the innovations further into marketable products and offer them to their target customers. In the case of technology-induced innovations, market success is often associated with high risks, as the acceptance by the customer can only be assessed with difficulty [Venkatesh/Davis (2000)]. At the same time, high prospective profits are possible, as a new product or process may lead to a sustained competitive advantage.

In the context of different innovations it is important for young enterprises to distinguish between a customer's view (added value) and a manufacturer's view (technology development). Both dimensions, which can differ from low to high, should be considered so as to identify whether an innovation is an evolutionary, technical, product/application specific or a revolutionary innovation. It is of high importance to induce a *customer-centric thinking*. Illustration 2-14 shows a systematisation of the different types of innovations along the added value and technology development dimensions.

***Illustration 2-14:*** *Types of innovation and added value*

| | | **manufacturer's view (technology development)** | |
|---|---|---|---|
| | | low | high |
| **customer's view (added value)** | low | evolutionary innovation | technical innovation |
| | high | product/ application-specific innovation | revolutionary innovation |

As an example, the success of *Google* can be traced back to a technology-induced innovation. The leading enterprise for internet search engines was founded in 1998 by Sergey Brin and Larry Page, two graduates of Stanford University in California. This success story started in the garage of a friend of the young entrepreneurs; while at college these founders had created a process which allowed a reliable assessment of the significance of a website. In one stroke, an innovative approach for the search of internet pages was developed. Before, the development of *Google*, search results were often inexact and the pages actually searched for were not always found. In order to avoid the weak points of the old search engine technology, *Google* uses the so-called PageRank technology. This technology analyses the complete link structure of the internet in order to find out which pages are really relevant for the current search request. *Google* combines the overall importance with the relevance for a specific search request, and is therefore able to supply reliable results. The aim is to achieve an objective evaluation of the significance of websites using the PageRank technology. Within this technology, an equation with 500 million variables and over 2 billion concepts is calculated. The PageRank technology interprets a link of internet page A onto internet page B as a "vote" of internet page A for internet page B, instead of counting only the direct links. PageRank then evaluates the importance of a page according to the collected votes. At the same time, the importance of each page giving a vote is taken into account. Pages which have been classified as important obtain a higher classification through PageRank with the result that these pages are given a leading position in the list of search results. It is important that no classification is made by humans as in the classic *Google* search, but that the structure and variables of the internet themselves produce the search results.

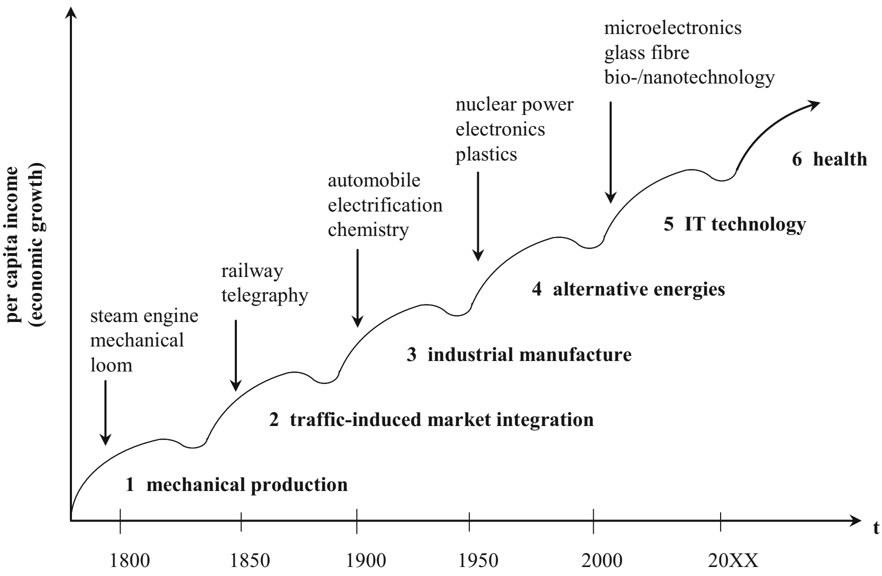
Brin and Page had also recognized that a new type of structure and organization of servers was necessary to supply exact and timely results to the user of a search engine. Until the formation of *Google*, search engines were operated via large servers. The disadvantage was that the latter usually worked more slowly, especially if large volumes of data had to be transmitted. In contrast to a few large servers, *Google* uses many linked PCs to quickly obtain results to search requests. This innovation led to shortened result times for search requests, a higher scalability or extensibility of the complete system and to lower costs. *Google*'s search engine as well as the image, blog and news services are run on PCs or servers which are combined into a cluster. As regards the total number of the individual computers as well as the total number of employed processors, only estimates based on information of the stock exchange in 2004 are available. According to these estimates, the number of computers ranges from 100,000 to 200,000 servers which are employed by *Google* for its operations. However high the exact number may be, such a large system certainly requires huge operational expenses.

In addition to the listed advantages, the employment of clusters of rather simple and cost-effective computers also has historical reasons. When developing the search technologies, Brin and Page only had the old and worn-out computers of Stanford University at their disposal. By necessity, they were forced to generate a fail-safe but fast system. A core competence lies therefore not only in the search algorithms or *PageRank technology* but to the same degree in the operation of the *Google* hardware structure.

With these unique technologies, Brin and Page succeeded in gaining a sustained competitive advantage over other businesses which had so far been leaders such as *Yahoo!*, *Altavista* and *Excite.* The search technique represented an improvement over the competitors, which led to an undisputed market-leadership for *Google* (in most countries). For example, the market share of *Google* in Germany has grown to about 90% over the past years. The global market share of *Google*'s search engine is around 80% to 85% [for the latest search engine statistics in Germany see www.webhits.de (Web-Barometer); global market shares can been seen at: marketshare.hitslink.com (Reports>Search engines)]. Generally, it should be noted that reported market shares may vary depending on the method of data collection used. However, certain common tendencies and relationships can be recognized. **Demand-induced innovations** are characterized by customer demand and market requirements for new innovations in terms of novel products and services (demand pull). Consumer needs and wished-for new products or improvements of existing ones have their origin in practical customer requirements. The chance for demand-induced innovations to be successful can be more easily assessed on the basis of existing products and experiences than in the case of technology-oriented innovations. The degree of innovation is, however, lower so that imitators and followers can easily penetrate the market, which will lead to an increased competition pressure.

From the point of view of *national economics* the alternation between periods of evolutionary and revolutionary innovations or sustaining and disruptive technologies in terms of products that generated a whole new market and lead to a *new economic growth* is described by the theory of long waves – the **Kondratieff cycle** (named after Russian scientist Nicolai Kondratieff). According to Joseph Schumpeter, real (revolutionary) basic innovations like the steam engine or the mechanical loom that can be seen as the starting point of the industrial revolution, lead to (high) economic growth or to a change in the *implementation or realization of new factor combinations in the form of new products or new qualities of a known product, new production methods, the opening-up of new sales markets, new organizational forms* or *new forms of procurement.* These waves stemming from bursts of revolutionary, often technological, innovations evolve into periods of minor, incremental innovations until the next wave emerges, driven by a novel technology. So far, five to six waves (mechanical production, traffic-induced market integration, industrial manufacturing, alternative energies, information technology and, maybe, an upcoming sixth wave involving health care and biotechnology) may be identified. [See Koch (2001)]

*Illustration 2-15: Kondratieff cycle*

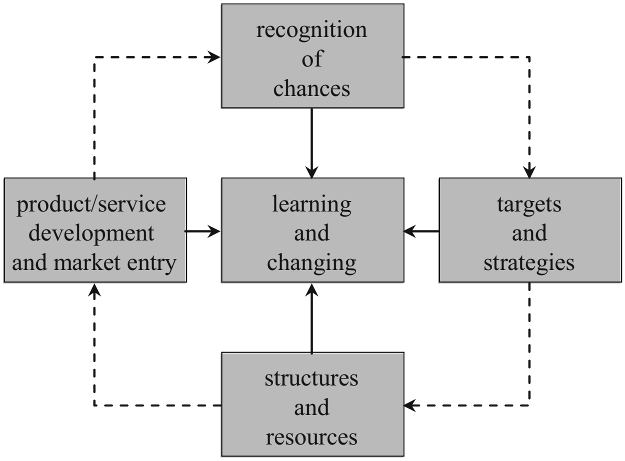



The different waves are argued to be fuelled by a broad spectrum of novel technologies or technical inventions, ranging from the steam engine to biotechnology. The diffusion of such new technologies into society is a very complex process making it hard to clearly identify dominant lead technologies. Often, such technologies may only be identified ex-post and still the clear demarcation of specific waves may remain dubious. Overall, it has to be noted that the empirical validity of Kondratieff's long waves has not been definitively proven yet.

**Innovation Process**

According to Tidd/Bessant/Pavitt (2005), the generation, adaptation, transfer and modification of knowledge can ideally be divided into various process-steps. A similar concept of the innovation process is Cooper's *stage gate process* which is based on a sequence of preliminary investigation (idea identification and initial screening and selection), detailed investigation (detailed second screening, business-case analysis), development, testing/validation, and final full production and market launch [Cooper (1998)]. On the basis of Tidd/Bessent/Pavitt (2005), Illustration 2-16 describes an ideal-type innovation process.

***Illustration 2-16:*** *Ideal-type innovation process*



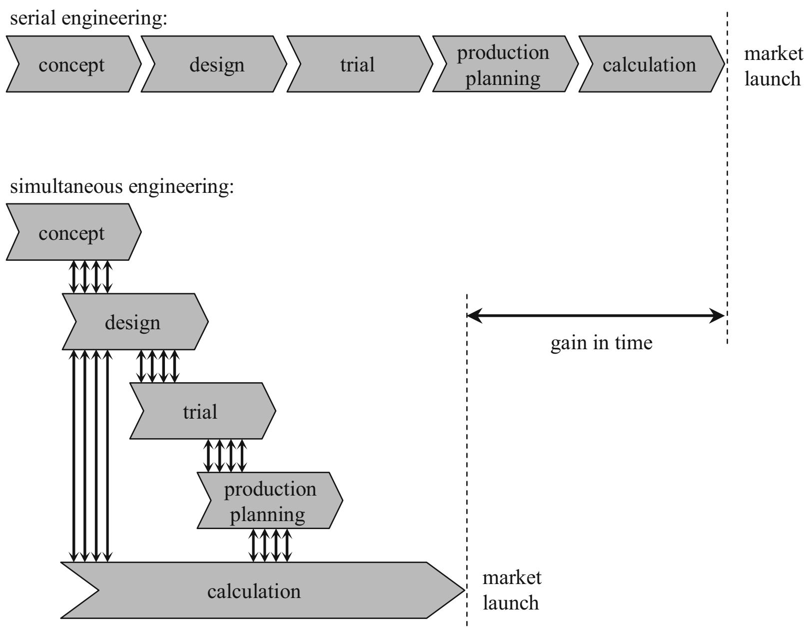

Based on this ideal-type process, first signals are received within the immediate environment of the enterprise and demands for new problem solutions as a basis for new products are identified at the beginning of the innovation process. The enterprise directs its activities to the search for improvement potentials, e.g., with regard to new ideas and prospective business fields, both within the enterprise and in the environment. This requires a multitude of information to be collected, analysed and examined with regard to its relevance. The examined information is then integrated into entrepreneurial decision processes.

Enterprises confront the innovation challenge strategically with the aim of strengthening or sustainably improving their competitiveness. During this process, a systematic, long-term orientation within the framework of their existing corporate and business strategies is primarily in the foreground. The identified economic opportunities and their technological feasibility are investigated as thoroughly as possible, in spite of the typically low maturity of the innovative ideas underpinning these opportunities. At the same time, considerations of their own competence rank highly.

During the subsequent phase, the attention centres on making resources available, above all the necessary knowledge and commitment of those concerned. The qualification of the employees, the availability and also the motivation for the new task, play an important role at this stage in addition to financing and the acquisition of external knowledge.

Finally, the concrete realization in terms of setting up production operations and market entry has to be tackled. Pushing forward the technical development (research and development, production) as well as market entry and sales activities (acquiring customers, marketing and distribution) rounds off the innovation process. [For more details, see Tidd/Bessant/Pavitt (2005); Spielkamp/Volkmann (2005).] Within this context it is important to mention that it might be a good idea to organize the process of, e.g., concept, design, trial, production planning and calculation of an innovation (be it a product or complex service innovation) simultaneously to gain time advantages compared to a serial engineering or innovation process. [Striving for a time edge should be compared to possible additional failure costs when running through the different steps of the innovation process simultaneously.] Note also that within a process of simultaneous engineering there are typically interdependencies and possible feedback loops between all stages. Illustration 2-17 gives an overview of a process of simultaneous engineering.

***Illustration 2-17:*** *Simultaneous engineering*




But not only **time-to-market**, defined from concept to market launch, is important but also **time-to-volume**, which means that the product has to be available in high quantities at its market launch. [In particular, volume is also essential because of possible economies of scale and cost competitiveness to be earned from higher output quantities.] Especially for young enterprises there is often only one chance for its new products. Therefore, especially a young enterprise's products should be available in such quantities and specifications so that the demand can be served. Otherwise the enterprise will suffer from substantial customer dissatisfaction which may threaten successful market entry. In addition, a young enterprise has to ensure that the product meets the expectations with regard to its marketed quality and functional range.

Finally, beyond the above ideal-type innovation process, there may be substantial heterogeneity and diversity in the innovation projects of individual enterprises which need to be taken into account when managing innovation both in young and established large enterprises [see Couchman et al. (2003)].

# 2.4 Comprehension Test and Recommended Literature

## Comprehension Test

- How could an idealized entrepreneurial process be illustrated graphically? (2.1.1)
- Discuss briefly the individual phases of the entrepreneurial process. (2.1.1)
- Which factors can have an influence on the individual decision process to start one's own business? (2.1.2)
- To what extent does the social environment have an influence on the start-up process? (2.1.2)
- Which potential motives for founding an enterprise do you know? (2.1.2)
- Discuss the concept of the “second chance”. (2.1.2)
- What is understood by the concept of an entrepreneurial opportunity? (2.2.1)
- How can an assessment of the environment of enterprises be carried out and why is this important in the start-up context? (2.1.1)
- How can entrepreneurial opportunities grow out of structural gaps? (2.2.1)
- Explain the concept of industry transformation. (2.2.1)
- What is an elevator pitch? (2.2.2.4)
- Differentiate between the concepts of invention, innovation and imitation. (2.3.1)
- What are typical triggers for an invention? (2.3.1)
- Explain the concepts of risk and uncertainty. Illustrate the differences between the two concepts. (2.3.2)
- Name and explain in detail the different types of innovation and their relevance in the entrepreneurship context. (2.3.2)
- What are sustaining technologies and disruptive technologies? (2.3.2)

## Recommended Literature

### Opportunity Recognition

*Ganglio, C. M.* (2004): So what is an entrepreneurial opportunity, in: *Butler, J. E.* (ed.): Opportunity identification and entrepreneurial behavior, Greenwich, 2004, pp. 115–134.

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### Innovation and Entrepreneurship

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*Burton, J.* (2001): Innovation, entrepreneurship and the firm: a post-Schumpeterian approach, in: International Journal of Entrepreneurship and Innovation Management, vol. 1, no. 1, 2001, pp. 1–21.

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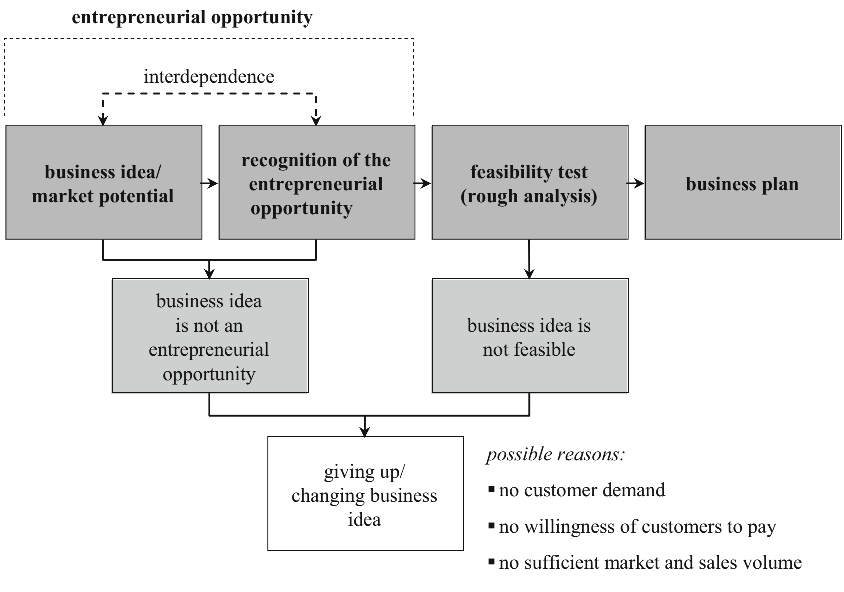
*Sarkar, S.* (2005): Innovation, entrepreneurship and development, in: International Journal of Entrepreneurship and Innovation Management, vol. 5, no. 5–6, 2005, pp. 359–365.

# 3 The Business Plan and Formation of the Enterprise

The future of an enterprise depends on sound prior planning; business **planning** contains the *intellectual anticipation of the future of an enterprise*, forming the nucleus for the later development of the enterprise. In advance of working out a comprehensive business plan, a short **feasibility study** is often carried out in order to investigate the fundamental practicability of the envisioned venture project by means of a preliminary rough analysis [Allen (2003)]. If no customer demand or willingness of customers to pay is detected for the intended product or service offer, this particular venture-project should, if considered realistically, already be abandoned in the phase of the feasibility study. Alternatively, after a successful rough analysis a detailed business plan can be prepared.

Illustration 3-1 shows a feasibility study which precedes the drawing up of the business plan.

***Illustration 3-1:*** *Feasibility study diagram*






C. K. Volkmann et al., *Entrepreneurship in a European Perspective*,
DOI 10.1007/978-3-8349-8752-5_3,

Potential questions which may be useful when doing the feasibility study are, among others:

- Is there a sufficiently large market and customer demand for the products or services?
- Who is the customer – and who will pay for the products or services (end user, trader, distribution partner)?
- Is the estimated market and sales volume sufficient for realizing the business project?
- Do the founder and the management team have the competence, knowledge and experience for realizing the business idea successfully?
- Are the first turnover- and cost-estimates plausible and transparent?

# 3.1 The Business Plan

## 3.1.1 Intention of a Business Plan

### 3.1.1.1 Significance and Target Groups of a Business Plan

The **business plan** is the structured systematic survey of the intended start-up project in written form with a **planning horizon** of *usually three to five years.* Considered in its entirety, it contains the intellectual anticipation of the start-up project and its successful market establishment and thus forms the basis for the realization of the business idea. "The development and writing of the business plan marks the transition from strategy formulation to the implementation stage of new venture creation" [Dollinger (2003), p. 127]. The business plan is the *core document of successful enterprise formation.* **Essential elements** of a business plan are detailed descriptions of *the products or services to be offered,* the *target market, potential customer benefits* and *possible competitors*, as well as planning information regarding *personnel and finance resources, organization, marketing, and sales.* In particular, the business plan forms an important basis for potential investors´ assessment of the economic viability and the prospects of the proposed venture project [see e.g., Faltin/Ripsas/Zimmer (1998)].

Often the necessity of a business plan is questioned, in particular by the founders. "We have all the important details of our planned business project in our heads" or "Once it has been completed, the plan is anyhow very quickly outdated" are typical reasons for not setting out the business plan in writing [cf. Delmar/Shane (2004a)]. It is true that in our fast-changing times prevailing circumstances have a sustained influence on the business plan so that it can date very quickly. Despite the fast-changing entrepreneurial environment, i.e., due to rapidly progressing technological developments, internationalization and globalization, as well as to increasing communication speeds, well-founded planning remains indispensable.

The necessity of planning is aptly described with a quote from Dwight D. Eisenhower:

> *"In preparing for battle I have always found that plans are useless, but planning is indispensable." [Dwight D. Eisenhower]*

Images from other walks of life illustrate the necessity of planning. There is barely a single successful film which has been produced without a script. However, the usefulness of a script for the producer can easily be compared to the usefulness of the business plan for enterprise founders. As for the *script,* the business plan forms the basis for the realization of the business idea to unfold over time. However, an essential difference is that the film will at some point be completed, but the enterprise will continue to live dynamically. In practical terms, this means that the contents and figures of the business plan must be continuously developed in enterprise planning, even after the formal establishment of the business and the construction of an initial capital base have been completed. For no rationally thinking and acting human being would steer a ship into the open sea with eyes shut.

In relationship to the outside world, the business plan serves, above all, to attract acquisition of capital from investors and lenders. In this way it constitutes the "business card" for the new enterprise and its management team. The business plan as a display of management competence of the entrepreneur is of vital importance precisely because the business has no existing track record on which reputation may be based. Because of this, business plans are an important initial signalling instrument for the future quality of the project and the commitment of its founders to see it through completion [Delmar/Shane (2004a)]. In essence, the business plan serves to attract the interest of investors for the planned business project. [Kuratko/Hodgetts (2001)], and is designed to enable potential investors to evaluate the economic practicability of the business model, its long-term market position as well as opportunities for an increase in the value of the enterprise in the future.

**Who should write the Business Plan?**

A basic rule is that the *founders should write the business plan themselves* rather than delegating this task to others. Even so, when drawing up the plan the seeking of advice and support of additional competent people (such as, for instance, enterprise or tax consultants who have specialized in the establishment of young enterprises) is recommended. Public sources of advice, e.g., through local small-business support agencies and chambers of commerce, may also be used, but founders should nevertheless write the plan themselves and know its content by heart. This is because the founders will need to manage their business once it is ongoing, and to ask investors and bankers for funding on the basis of their business plan.

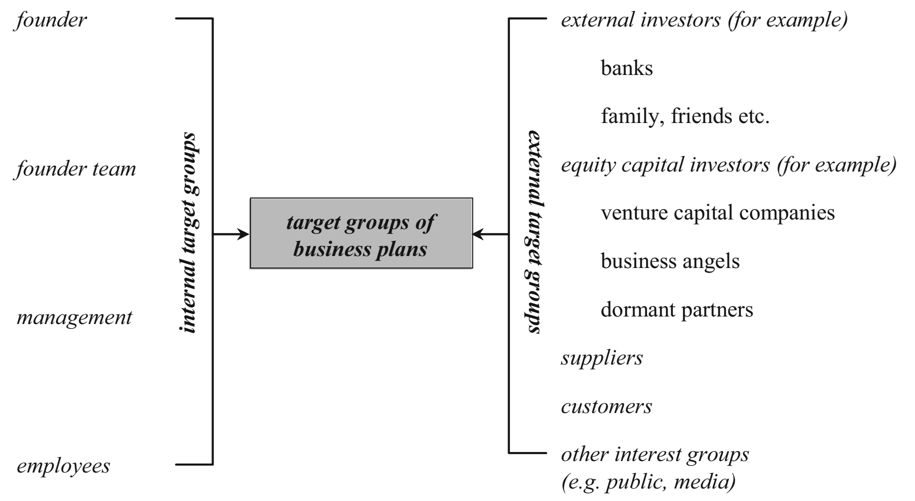
The business plan is normally not written in one go, but developed over a long period of time, for it is an evolutionary process, which develops with the realization of the business idea. Drawing up the business plan forces the founders to think through, systematize and structure their business idea. At the same time, weak points (e.g., lack of resources and gaps of knowledge) can be avoided or made transparent and eliminated in subsequent steps. Within the enterprise, the business plan is an important *navigation instrument for management.* By writing the business plan, the process of enterprise-formation and early development is assisted in a structured manner. It is thus an important experience for the founders to write a business plan, to reflect at an early stage upon the guiding questions of the venture, e.g., with regard to market potential and capital requirement, and to concretely set out these thoughts on paper [Allen (2003)]. Guiding questions in this context are, for example: Is my business idea economically practicable? Who will be my customers? Are there any protection rights for my business idea? Who are my competitors? Am I capable of managing an enterprise? These questions must be answered by the founders in the process of drawing up their business plan. In addition, it is useful to develop different scenarios and to anticipate possible obstacles on the way of founding the business and establishing it on the market. Some statements of the business plan will need to be based on managerial assumptions made by the entrepreneur. These assumptions should be explained comprehensibly to potential investors and other readers of the business plan.

The creation of a business plan is for many founders associated with a fundamental process of knowledge gathering, which will be useful in later stages of enterprise development. In some cases, the project already ends with the writing of the plan, i.e., when the project does not prove to be feasible. A business plan which in the end is not realized is, however, less costly than a failed start-up enterprise to which the founders would have committed substantial amounts of time and money.

**What are the Essential Target Groups of a Business Plan?**

There are various target groups, which a business plan normally addresses. The most important target groups can be divided into internal and external target groups as shown in Illustration 3-2.

***Illustration 3-2:*** *Internal and external target groups of the business plan*




Each of these target groups has its own interests in the business plan. Good business plans comprehend and satisfy the interests of the relevant target groups.

Primarily, the founders draw up the business plan for internal purposes, i.e., for themselves, their partners, their management as well as their future employees. Only secondarily does it serve *external target groups* such as potential strategic partners or equity investors. With regards to the *internal target groups*, the business plan gains fundamental importance as an internal planning and controlling tool, which is not only employed once at the time of business formation, but repeatedly and regularly within future continuous enterprise planning. Externally, the business plan serves above all as an instrument for raising capital, in that potential financiers require the presentation of a business plan. Oftentimes, at least a summary or a draft has to be submitted even before the first negotiations with investors and bankers can take place [Mason/Stark (2002)]. The trust of potential investors can only be gained with the help of a transparent business plan with a sound business idea, underpinned by solid figures. The different target groups that read and evaluate the business plan of new enterprises may look at a wide range of aspects with regard to the start-up project and founding team. For example, Beaver (2002) and Scarborough/Zimmerer (2003) discuss common lists of criteria which are used (e.g., by bankers) to assess business plans: the **five C's** *(capital, capacity, collateral, character, conditions)* and the **"CAMPARI" list** *(character, ability, management, purpose, amount, repayment, insurance).*

### 3.1.1.2 Requirements for a Business Plan

**Requirements for a business plan** can be formulated in a general way or specifically relating to the start-up project in question. The general requirements refer to form, content and time-scale of the plan. In the relevant literature, very detailed representations concerning the general requirements of a business plan can be found [see, for example, Allen (2003), Dollinger (2003) or Timmons/Spinelli (2004)]. Here are a few basic notes drawn from this literature:

- Under **formal aspects** a business plan should be reader-friendly, easy to understand, structured, meaningful and in its form also be visually attractive. The wording should be precise and without deviation. Technical terms and complicated technical facts should be presented in a simplified way. A clear progress plan can facilitate the understanding of the reader. In addition, the coherence of all the plan's parts must be ensured. It is, for instance, necessary that the results from quantitative planning of sales volumes match the respective turnover-sales planning.
- The **planning content** should be as complete as possible and take into account all important planning aspects (e.g., business idea, market and competition, personnel and financial resources). The data and information sources which form the basis for the planning process should be sound and factual, comprehensible and without contradictions. In this context, it is essential that the opportunities and risks of the venture project are assessed as comprehensively and realistically as possible.
- When determining the **planning horizon** (time schedule), the length and time-graduation of the planning period are of special importance. In practice, a planning period of five years is often chosen. The first business year is planned in months, the second in quarters, the third half-yearly and from the fourth business year onwards in years. The first year of business needs to be planned on a monthly basis in order to track cash outflows and inflows as they actually occur. This is to avoid problems of liquidity and to track effects of seasonality (e.g., in retail start-ups where forth quarter sales figures may be stronger than during the rest of the year). In addition, it has to be taken into consideration that with longer planning horizons the uncertainty of planning content and data also increases.

The depth and degree of detail in a business plan depends above all on the size and scope of the planned business project. For starting a capital-intensive biotechnology enterprise or an airline company, more comprehensive business plans with a comparatively higher degree of detail are required than for the establishment of a small engineering office. The size of the market, the number of (potential) competitors and the planned growth of the enterprise are further determining factors which can influence the complexity of the business plan.

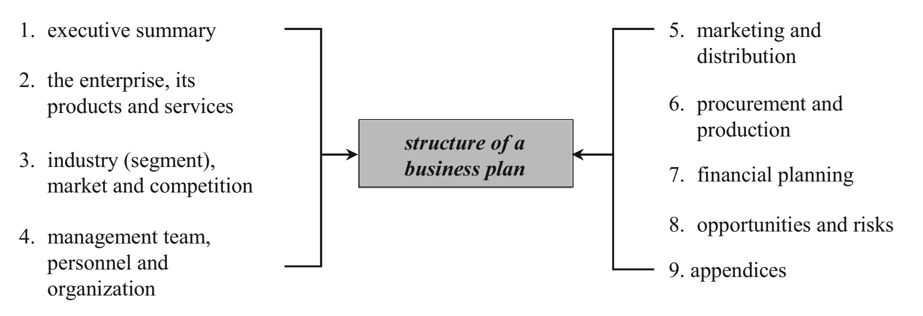
Based on practical experience, a business plan should not exceed 35-40 pages. To allow the reader a quick overview, a content index should head the business plan. In the appendices, important supplementary explanations and details should be added. A high-technology enterprise may require additional appendix pages which explain necessary details of patent information and production processes. Nevertheless, in principle, the business plan should be kept as brief and to the point as possible, but no essential facts concerning the start-up project and its planned development should be omitted. During a critical check of the business plan it may be helpful for the founders to put themselves into the investors' place considering aspects of comprehensibility and plausibility or to invite others to read the plan and offer their feedback.

### 3.1.2 Proposals for Structuring Business Plans

This section will deal with the specific contents of a business plan and how they may be arranged. However, only some essential aspects will be presented, as there are already a large number of general structuring and navigation aids available for the practical drawing up of the plan in the form of manuals, guidelines and check lists. [As regards textbook sources, see e.g., Struck (2001); Stutely (2002); Allen (2003), Timmons/Spinelli (2004); Nagl (2005) or Klandt (2006).] Business plans can differ according to the sector the enterprise is operating in and the individual characteristics and features of the enterprise. This means that the "ultimate" ideal business plan does not exist [Struck, (2001); Kuratko/Hodgetts (2001)].

Illustration 3-3 shows a proposal for the structuring of a business plan.

***Illustration 3-3:*** *Structure of a business plan*




Based on Illustration 3-3, the following detailed structural proposal for business plans, as well as the explanations of the individual building blocks, should only be understood as orientation aids.

**1. Executive summary**

- Business idea
- Central aims and strategies of the enterprise
- Target market
- Customer benefit/competitive edge/possibly unique selling proposition
- Overview of founder team and key management personnel
- Survey of the financial plan
- Capital requirement

**2. The enterprise, its products and services**

- Purpose and aims of the enterprise
- Data concerning the enterprise (business name, address, date of founding/incorporation etc.)
- Legal form and company structure (reasons for the choice of legal form, partnership conditions, business management)
- Location(s) (location description, location advantages)
- Product/service offer
- Level of technology, patents, licences
- Research and development, quality assurance
- Core benefits for customers
- Competitive advantages
- Product-related risks (threat of substitutes etc.)

**3. Industry, market and competition**

- Market data and market research information
- Market evaluation (target markets, market volume, market potential/growth)
- Market share (current/planned)
- (Potential) market entry barriers
- Positioning within the industry value chain
- Direct and indirect competitors, including possible substitute products/services

**4. Management team, personnel and organization**
- *Curricula vitae* of the management team (brief)
- Motivation and qualifications (academic, professional, in particular industry experience)
- Leadership competences; entrepreneurial and management experience
- Distribution of tasks and responsibilities in the founder/management team
- Potential deficits in qualifications/competences (and how these gaps will be addressed)
- Participation in other enterprises
- Advisory board/board of directors (if applicable)
- Advisors (number, assigned tasks)
- Employees (number, qualifications, roles and positions, distribution of tasks)
- Organizational structure (divisions, departments etc.; if applicable)
- Personnel requirement (open positions to be filled), procurement and development
- Co-operations (e.g., industry or technology partners), networks

**5. Marketing and distribution**
- Price policy
- Product policy
- Communication policy
- Distribution policy
- overall marketing plan (market segmentation, target customers, positioning)

**6. Procurement, production**
- Purchasing and procurement, channels and prices
- Dependences on suppliers, binding purchasing contracts
- Production, factory equipment
- Production processes
- Protection of the environment

**7. Financial planning**

- Reporting and management accounting systems
- Turnover plan (sales plan), capital expenditure plan
- Cost budgets (personnel, material, promotion etc.)
- Pro forma profit and loss account and balance sheet
- Pro forma cash flow (liquidity) plan
- Capital requirement and financing

**8. Opportunities and risks**

- Presentation of opportunities and risks
- Risk management strategies

**9. Appendices**

- Curricula vitae of founders (detailed)
- References
- Organigram
- Company or partnership agreement, excerpt from commercial register
- Contracts (licensing, purchasing, leasing and hiring contracts, letters of intent etc.)
- Permissions by the authorities
- Production plans, progress plans
- Detailed product specifications
- Time plan, implementation plan

### 3.1.2.1 Executive Summary

The executive summary of a business plan describes briefly and clearly the underlying business idea and essence of the business concept, including the essential aspects of the start-up project, including the founder team, the products or services offered, industry and target market, customer benefit and advantages over competition and a snap-shot of financial projections (in particular the required amount of capital). It should not be interpreted as a mere content-index or an introduction to the business plan. Rather, the summary should be a stand-alone element of the business plan which serves to give readers and decision-makers, in particular investors, a quick overview of the start-up project, so to gain their interest and to motivate them to read the complete business plan. Probable investors (like venture capital companies) receive many business plans, and their decision-makers will not read for longer than five to ten minutes, unless the summary has already convinced them that the project may be an interesting investment to be considered further. Thus, it is recommended that the founders should write the executive summary, which should not be longer than two pages, only *after* having completed the entire business plan. The summary's quality will determine whether potential equity and debt financiers like business angels or bankers will examine the complete business plan or put it (prematurely) aside. For this reason, special attention should be given to the guidance herein presented.

Central elements of the summary are: *business idea, central aims and strategies of the enterprise, target market, usefulness for customers, competitive edge, survey of founder team, an overview of financial projections and capital requirements* and possibly a *planned exit strategy* for institutional equity investors (e.g., trade sale, listing on the stock exchange). Possible guiding questions for writing the executive summary are:

- What is the business idea/the business model?
- Which markets or market segments will be served and what will be the product and service offer of the enterprise?
- Who are the target customers/which are to be the mainstays of sales?
- What is the planned market entry strategy?
- What is the accessible market volume which can realistically be tapped by the enterprise?
- What are the benefits for the customer?
- Is there a unique selling proposition which offers a sustainable advantage over competition?
- What important milestones are to be reached in developing the business?
- What do financial projections (pro forma income and cash flow statements) look like for the next three to five years?
- How much external capital will be required to fund the establishment and early development of the business until the break-even point is reached?

#### 3.1.2.2 Enterprise, Products and Services

**Object, Aims and Strategies of the Enterprise**
In this section, the enterprise with its product or service offers will be described with regard to current and future market demand. First of all, it must recognizable for investors whether the business idea refers to a manufacturing enterprise or to a services start-up. Regardless if a new enterprise is to be founded or an existing enterprise is to be taken over, potential financiers will be interested in the business model and the

offered product or service range. The profile of the enterprise comprises essential data concerning the business organization, the choice of legal form, location, as well as the planned ownership structure. The business model describes the underlying business idea and perceived entrepreneurial opportunity, as well as the means and ways for realizing this idea. Financially, the business model takes into account the costs and the obtainable gross profit from sales based on the business idea underpinning the start-up project. The business model illustrates the resources which are available to the enterprise, and shows how these inputs transform outputs and profits. It is thus vital to communicate the fundamental object, aims and strategies of the enterprise to readers of the business plan.

The following questions should help founders to clarify their purpose and facts-on-the-ground:

- What is the purpose of the business?
- Is the business project a new enterprise, takeover, management buy-out (MBO), management buy-in (MBI) or franchising?
- What customer benefit is connected with the product or service offer?
- Which markets/market segments, product or service areas are covered?
- Which target groups are to be addressed?
- Why will the business model be profitable? What constitutes the growth prospects of the venture?
- Which legal form is planned and why?
- Which location is to be chosen and why?
- What company structure shall the enterprise have?

**Aims**
Many successful enterprise founders have visions from which their enterprise's aims emerge. A key to a sustained success of newly emerging enterprises consists in developing a visionary enterprise and to transform it into a living entity. A specific aspect of entrepreneurship is the ability of founders to create such a vision from almost nothing, in other words to build a business from scratch without an existing resource base [Timmons/Spinelli (2004); Brush (2001)]. "*We make the world safer*", may, for instance, be the vision of a security enterprise to be established, and from this vision, the aims of the enterprise will develop. It is essential to formulate these aims in a graphic, engaging language and in an encompassing fashion, including the employees, business partners and possibly the investors and the public [Loansbury/Glynn (2001)]. It is important that larger visions and specific aims are complementary, for aims become the beacons on the way to entrepreneurial success [Opoczynski/Thomsen (2003)].

The aims should be formulated in writing, in that written aims are verifiable, and the extent to which the aims are reached can usually be measured. Aims must thus be both coherent and obtainable. Therefore, it is not recommended to formulate too many aims [See also vision and aims in chapter 7.2]. "In the course of the next three years, we want to increase the turnover by 30 percent per annum, reduce costs by 20 percent, develop new products yearly and have an excellent working atmosphere." This is scarcely a realistic set of targets for an enterprise. With the formulation of a set of attainable and coherent goals, the future direction of the enterprise is determined.

The check-list in Illustration 3-4 is designed to assist in determining a suitable set of strategic objectives for a new enterprise.

***Illustration 3-4:*** *Check-list for target system for defining strategic objectives*

| ***check list – defining attainable and coherent strategic objectives*** | |
|---|---|
| *financial objectives* → | improve annual profit; improve turnover; improve costs |
| *market/competition objectives* → | market share of x %; achieve competitive advantages through niche strategies |
| *ecological objectives* → | prepare an eco-balance sheet; test environmental friendliness of products |
| *sales objectives* → | achieve a ratio of x:x in supply to orders; shorten the sales cycle to x months |
| *marketing objectives* → | noticeable market image; demand should increase each month by x % |
| *quality objectives* → | build a consistent, systematic sales process and uniform product quality |
| *immaterial objectives* → | improve quality of customers, company image and satisfaction of employees |
| *ethical objectives* → | manufacture ethically defendable products, ban child labour and ensure fair worker remuneration |

In addition to the examples in Illustration 3-4, the agreed objectives must be clear, unequivocal and precise. They should be formulated positively, e.g., to become the market-leader or achieve an annual turnover of 5 million Euro etc. It is essential to verify regularly how far the set objectives have been achieved.

**Strategies**

A basic task of the founders is to develop strategies and to implement them with regard to set goals. In this context, it is essential for the successful establishment of a start-up to lay down growth strategies or strategies for securing the existence of the enterprise. Particularly in the area of small and micro start-up businesses where often no (or limited growth) is intended [Aldrich (1999)], it is important to develop strategies which will secure the permanence of the enterprise. Irrespective of the chosen basic strategy, it is important for successful founders to distinguish themselves from competitors through specific customer benefits of their product and service offers. When choosing their strategies, founders should proceed with care, as they are at that moment positioning the planned enterprise in the market and thereby against competitors. In order to achieve competitive advantages, there are three different types of **strategies** according to Porter: *Cost leadership, product differentiation* and *concentration on key areas.*

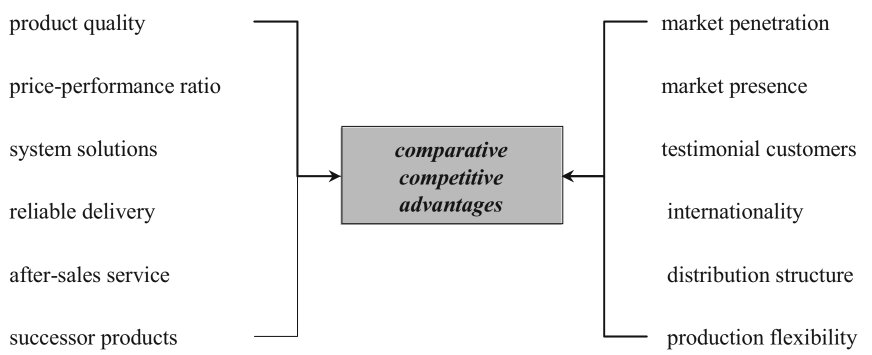
The characteristic feature of a strategy of **cost leadership** or cost superiority is that competitive advantages are realized through comparably lower costs of an enterprise in the relevant industry segment. This strategy functions particularly well in markets with high price sensitivity. A high output, efficient production plants, the exploitation of knowledge transfer, as well as the consistent utilization of opportunities for cost-cutting, e.g., through favourable purchases, are characteristic features of the strategy of cost-leadership. In practice, cost-leadership is often associated with mass production and standardized products. Therefore, "this strategy is very difficult for a new venture to implement in that it is more often the result of being further along on the experience curve and producing in high volumes" [Allen (2003), p. 90]. However, while large, established companies may benefit from advantages of size (e.g., economies of scale), small and new enterprises may still keep costs low with a lean and cost-efficient organizational structure. The risks of this strategy consist above all in the threat of heavy price-competition, as well as in the generation of a cheap image.

The strategy of **differentiation** is oriented towards distinguishing the enterprise from the competitors through uniqueness, thus creating a clearly recognizable additional advantage for the customers. In this case, competitive advantage is achieved based on unique products or services for which customers are prepared to pay a higher price. Differentiation of the products and services can, for instance, be achieved through differentiation of product properties (such as innovation, quality, design) and/or differentiation of service offers (pre-sales-service, distribution service, after-sales-service; that is, service augmentation). The main risk of this strategy is the threat posed by imitators who might try to transfer the differentiation advantages to their own product offer.

The strategy of **concentration on key areas** (a so-called niche strategy) consists in specializing on a certain product or customer group, or a regionally demarcated market niche. This strategy means focussing on small market niches, which are often neglected by larger competitors. In practice, such niches are worked on either with the strategy of cost leadership or differentiation. The chosen market niche should be characterized by sufficient size, purchasing power and growth potential. An essential risk of this strategy consists in the entry of competitors, who have identified the niche as an attractive market.

Illustration 3-5 gives an overview of possible comparative competitive advantages.

***Illustration 3-5:*** *Comparative competitive advantages*




The listed comparative competitive advantages are closely linked to the range of products and services of a young enterprise and should be viewed in relation to the competitors in the target market.

Guiding questions in this context are:

- What objectives will the enterprise pursue in the next five years?
- What are the critical success factors for reaching these objectives?
- By means of which basic strategy can the targets be reached?
- What strategy is designed to achieve a sustained competitive advantage?
- How shall a successful implementation of the strategies be achieved?

**Range of Products and Services Offered**
The product or the service of a new enterprise usually enters into competition with other products or services which are already available in the market, where their respective success is decided by the customer. Quality and price of the product or service offer must be recognizably better in the eyes of the customer than competitive offers in order to arouse the inclination to buy. For a start, a simple method for checking the perception of product advantages by target customers is usually achieved when the founders place themselves into the position of the customers and ask themselves whether they would buy their own products or rather those of their competitors.

Innovative products often require an explanation, and it may take a long time until they are accepted by the customers [Aldrich/Martinez (2003)]. It is therefore essential to convince the customers of the benefits of the innovation in comparison with competing products, therefore, the special features of the product or service idea should be described and the competitive advantages discussed. A functioning prototype, as well as one or more pilot customers, can have a convincing effect on external investors. [For a discussion of reputation signalling through pilot or testimonial customers in young enterprises see Reuber/Fischer (2005).] In the case of a research-intensive new enterprise, the research and development aims, budgets and time plans should be added in the appendices, and the technological risks of the products must be explicitly explained. In this context, questions about patent and licence rights are relevant and existing or planned protection rights should be presented. To allow a better assessment of the risks involved in the start-up project, possible imitations through competitors or possible protection rights of competitors should be discussed. In addition it is necessary to state whether additional innovations or further developments of core products are planned. The following guiding questions should contribute to the planning of the range of products or services to be offered:

- What products does the enterprise offer?
- What does the product or service innovation consist of?
- Does the enterprise have patent or licence rights?
- What legal requirements/regulations exist concerning the product or service offer?
- What advantages and benefits exist for which groups of customers?
- Which auxiliary services (e.g., after-sales-service and maintenance support) can the enterprise offer as opposed to its competitors? Does it grant special product or service guarantees?
- What are the existing competitive products or those under development?
- What patents/licences do the competitors have?
- What further development steps for an improvement of the product or service offer are planned?

#### 3.1.2.3 Industry, Market and Competition

Lacking or insufficient market knowledge is often the reason for the failure of new enterprises. It is necessary already prior to founding the enterprise to consider in detail the industry segment the enterprise will operate in, the overall market, its customers and competitors. During this process, it is recommended to reflect on the following aspects and steps:

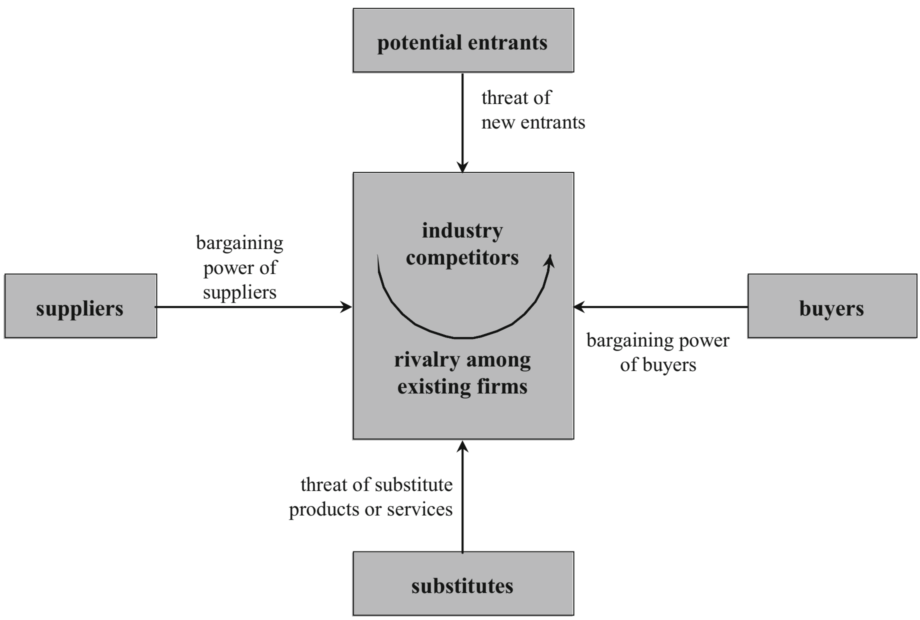
- Search for and procurement of information (procurement of relevant industry, market and competition information)
- In-depth analysis of the collected industry segment, market and competition information (development of sales in the industry segment during the last five years, market growth, number of new competitors in the sector during the last three years, importance of product innovations in the line of business etc.)
- Description of prevailing market conditions and environment (e.g., economic, legal, demographic, political conditions, technological progress)
- Representation of the key driving factors which influence the relevant industry segment as well as important future trends of the business sector (including the expected growth in the next few years)
- Analysis of the competition situation and strategies (essential competitors as well as their strengths and weaknesses, competition advantages, market entry barriers etc.)
- Segmentation and description of the relevant target market (including estimates of market potential, sales volumes and market shares)
- Estimates of price and sales development, operating margins and the overall profitability of the target market segment in the future.

**Line of Business, Total Market**
It is important to describe in the business plan the line of business and the overall market in which the enterprise plans to operate. Many founders are not aware of the present position of the enterprise in the industry sector and often do not anticipate which developments their industry will make in the future (via new technologies or legal prevailing conditions), and how they will react to them. The detection of important future trends and the explanation of the main factors which influence the industry segment are required for answering the question whether a market entry will be profitable.

To describe the nature of an industry or industry segment Porter's five forces framework provides a useful tool. [For a discussion of the framework in the entrepreneurship context see, for example, Allen (2003), p. 80.] Note that an industry may have different segments which can vary substantially in their characteristics and attractiveness. For example, in the sports wear industry non-branded sports wear differs considerably from the up-scale segment of premium brand manufacturers like *Nike* or *Adidas*. The bargaining power of buyers will be much lower while the market-entry barriers for new competitors will be higher, both making the market more attractive to operate in (but challenging for young enterprises as new entrants). Therefore, industry analysis may work best at the level of a specific industry segment sighted by the enterprise. Put simply, an industry segment consists of a group of enterprises which sell similar or closely related products to their customers. According to Porter, the structure of an industry and its attractiveness depends on **five competition forces:** *Market entry of new competitors/potential entrants, threat of substitute products, bargaining power of buyers, bargaining power of suppliers and direct competitive rivalry amongst the existing competitors in the industry.*

In conclusion, the following Illustration 3-6 is designed to illustrate the model of the **five competition forces** according to Porter (1999).

***Illustration 3-6:*** *Five competition forces according to Porter*



**Market Analysis and Forecasts**

Statements regarding future market developments and forecasts are fundamental components of a business plan. From the entrepreneurial point of view, products and services only offer an economic value if a market exists for them or can be created. Market analysis gives a realistic impression of the market to be worked in, taking into account the relevant influencing factors, such as Porter's five forces.

The market analysis covers in particular the following areas:

- Search and procurement of information
- Analysis of the total market
- Market attractiveness
- Market segmentation

Procuring information is necessary to facilitate an exact description of the relevant market, market segments and their respective attractiveness. The quality of the market analysis depends decisively on the quality of the available information. The sounder the data and information basis, the better are the forecasts which can be made for the enterprise and its future. In particular, the more exact the information and data referring to the relevant market, the more precise can be the sales and turnover planning later on.

Because of the limited resource base of new enterprises (as compared to the deep pockets of large multinational companies who may simply commission a market research agency), a little creativity is required when procuring information. Relevant information sources are, for example:

- Literature (e.g., books, specialist journals, newspapers, market studies)
- Associations and authorities (national offices for statistics, chambers of commerce and industry, patent offices)
- Economic research institutes, universities
- Commercial data banks
- Internet (e.g., *Google*)
- Trade-fairs, exhibitions
- Other information sources (e.g., credit institutes, credit agencies)
- Interviews with experts

[For additional potential sources of information, see Allen (2003).] The following questions are designed to structure and carry out market analysis and make market forecasts:

- How large and attractive is the total market?

- How large is the expected growth in the sighted industry segment?
- Where is the industry positioned on the life-cycle curve?
- Is there an existing market demand or is it to be created first?
- What are the most important business operating conditions?
- Which criteria determine the attractiveness of the market?
- What influence do innovations and technological developments have on the target market?
- How large is the target market of the enterprise?

**Market Segmentation**

An essential question for founders is what market or which market segment is to be served. Market segmentation is produced by the formation of individual groups of customers, who all show a similar behaviour or similar characteristics. The more precisely the segmentation criteria are chosen, the more specific the target groups can be differentiated. When forming homogeneous customer groups it must be ensured that all customers can be reached with the same communication strategy. Examples for segmentation criteria are purchasing behaviour, regions, demographic or psycho-graphic criteria (attitudes, preferences etc.). The customer needs and wishes are meant to be met more systematically and demand-related, if a target market is used which has been segmented according to such criteria. The specific offer of the competitors to this target-group should be included in the investigation. Target customer groups could be, for example, all single households with a gross income of over 150,000 Euro per year which possess a Porsche and smoke.

In this way, customer groups can be determined. However, for new enterprises with limited advertising and marketing budgets it is essential that the targeted customer segment can be addressed and reached effectively through communication and distribution strategies. The size of the relevant market segment should be seen in relation to the total market, for the aim is to accurately establish the potential sales volume in this market segment. The size of the target market should be sufficiently large to make the business project profitable. Possible questions in this context are, for instance:

- What are the relevant socio-economic criteria of the target group?
- What are the relevant demographic criteria of the target group?
- What are the relevant psycho-graphic criteria of the target group?
- What are the relevant wishes and emotions of the target group?
- Which regions are relevant?

**Competition**

The pre-condition for a successful positioning in an industry sector is to know the relevant competitors; these can be divided into three groups:

- Direct competitors, who offer comparable products or services
- Indirect competitors who offer replacement or substitute products
- Potential competitors who are not yet represented in the same market segment, but the risk of their market entry exists.

This means that in addition to existing or potential competition enterprises, the founders must also concern themselves with the threat of possible substitutes. (Substitute products are products which meet the same customer needs in a different way. Examples for substitutes are coffee and tea, video CD and DVD, portable CD-players and MP3-players.)

In relation to the possible competition many questions are of interest. It can, for example, be difficult to discover who the most important competitors are, which market share they possess, and what strengths and weaknesses they have. Also of interest is what advantages the competitors have, e.g., with regard to cost structure, product design, distribution channels or after-sales service. The analysis of potential influencing factors is also significant, as, for example the possible effects of the market entry of new vendors on their own business success. In this context founders should ask how quickly and at what expense their own business can be copied and how difficult the market entry barriers for new competitors in the industry sector are. Questions in relation to the competition could be:

- Which important competitors offer comparable products and/or services?
- What new developments are to be expected?
- Which target groups do the competitors address?
- What market shares do the competitors have?
- What cost structures do the competitors have?
- How profitable are the competitors?
- Which distribution channels do the competitors use?
- What are the relevant competitive advantages in the industry?

### 3.1.2.4 Founder Team, Personnel and Organization

**Founder Team**

The founder team is decisive for the success of a start-up project and the growth of a young enterprise. Often questions of leadership do not yet play a role at the time of founding, as the founders usually start their entrepreneurial activity alone or only with a small number of staff. However, in the case of an enterprise oriented towards growth it is decisive for the investors whether the founders have the necessary capabilities and skills for managing a rapidly growing enterprise successfully. Many joint ventures prefer an excellent management with a mediocre product to a mediocre management with a first-class product [Bygrave (1997)].

After the summary of the business plan, the section on the founders or management is often the next passage which will be read by potential financiers. The high importance of the evaluation of the enterprise's management team is often underestimated by the founders [Struck (2001)]. External financiers like venture capital and business angel investors base their investment decision to a considerable extent on the personalities of the founders or the management team [Manigart et al. (1997), Mason/Stark (2002)]. In this context, it is often discussed in literature and in practice which properties or characteristics an entrepreneur should have.

The question what makes a successful entrepreneur and what general demands are to be made on the founder is not easily answered. In a wide spectrum the opinions reach from "the consideration of the entrepreneur's personality is of no importance at all" to "indispensable".

Generally speaking, the personalities of people are too complex and different to allow any basic statements and to classify them into a universally valid scheme.

> *"If my experience has only taught me one thing: It is almost impossible to anticipate what makes a successful entrepreneur." [Vesper (1998)]*

Nevertheless, it is in practice important for investors to assess the entrepreneur's personality in order to be able to make a decision on financing. Which are the aspects of the founders that interest financiers when looking at a business plan? A significant clue is, primarily, the career development or history of the founders, which will show the professional success the founders have already achieved. Moreover, the career history gives an indication of the industry experience, management competence, and entrepreneurial capability of the founder team. In addition the question of the founders' motivation is important. [This is particularly so to business angels, who make not only passive financial investments in start-ups but also plan to work closely with the founders over a period of time, see Osnabrugge/Robbinson (2000).] Motives may be a greater freedom of decision-making and independence, desire for self-realization (creative work), the realization of new ideas, a professional crisis situation (e.g., job loss), want for prestige gain or higher potential earnings [Schelzke (1990)]. The question of the motives for founding a new enterprise is raised frequently by investors and should be answered by the founders convincingly.

New-venture projects are associated with considerable rewards for the people involved, however they also carry substantial risks (e.g., insecure income, irregular working hours, less leisure or family-time). Founders should therefore weigh up the opportunities and risks against each other in advance of taking irreversible steps towards founding the business. To begin with, it is recommended that a founder self-critically examines whether he/she is suitable and what are his/her strengths and weaknesses. The conclusion reached here can come from a standardized questionnaire or talks with others (partners, good friends, advisers).

This section deals with a description of the specific characteristics and competences of the founder or management team. Of interest are, above all, leadership, professional experience, training and specific qualifications, for it is essential that the founder team has complementary competences with a common vision. If deficits or weaknesses are recognizable in the founders, these should be listed in the business plan, and any measures planned to overcome them should be explained. The *curricula vitae* of the enterprise founders and key management team, together with their professional histories, are to be listed in the form of tables in the appendix, and certificates and possibly references should be added. In this context, the following questions could help in collecting and organizing this section of the business plan:

- What are the professional careers of the founder(s)/the management?
- Who should be responsible for which areas of the enterprise?
- What are the specific qualifications and experiences available?
- Is there any requirement for strengthening the founder team in individual positions?
- What agreements are planned with external advisers?

**Personnel Planning**

Not all start-ups want to employ personnel. Therefore this section in the business plan has a different relevance for different venture projects depending on their planned size of operations. With this in mind, the following explanations refer primarily to growth-oriented enterprise start-ups, for which a systematic personnel planning is important to ensure the future success of the enterprise. Generally, the business plan should contain information about the required personnel with regard to type and number, qualification and costs, as mistakes made in the personnel planning can be expensive and can cause critical problems. Therefore, establishing the right balance of demand, recruitment and the correct employment of qualified staff is particularly important. The personal and professional qualifications of employees should correspond to the requirements of the enterprise. The generation of a requirement profile is very useful in this respect. The actual profile of the prospective employees should as far as possible be congruent with the ideal profiles of the positions to be filled. As in the start-up and early development phase, a direct communication and cooperation between the founders and the employees usually exists, it is especially important that the team members get along with each other. It is typical of the founding phase of an enterprise that several tasks are taken on temporarily by one person and that there is only little division of labour (a typical internal liability of newness in start-up enterprises). In particular, if the founder team does not yet have all essential competences for establishing and growing the new enterprise (e.g., lacking industry experience or accounting skills), these gaps must be listed in the business plan and it must be clear when and how the team will be completed. Some key questions arising in this context are:

- Can enough qualified staff be acquired from the region?
- What incentives should be given to new employees?
- Will there be an employee stock-option scheme for key personnel to participate in the success of the business in order to foster employee loyalty and motivation?
- Are the employees bound long-term to the enterprise?

**Organizational Planning**

The planning of the organization of a new enterprise refers to devising an effective organizational structure and process organization for the business. In analogy to personnel planning, the organization arrangement is not relevant for all start-up projects. For small enterprises employing three or four people a formal organization structure is scarcely worthwhile. The creation of a differentiated structure, which may be presented in an organigram, is especially helpful for larger start-up enterprises in order to obtain an overview of the planned responsibility areas and formal decisional authorities. At start-up and after founding, often informal structures prevail. In small enterprises not oriented towards growth, these often continue for years. Functional organization structures are often established as the enterprise increases in size. If teams are to be assembled for specific products, actions or projects complementing the organization structure, these should be mentioned in the business plan.

With regard to process organization, the business plan should raise the question with which approach and methods the operational processes and workflows are to be structured and optimized. The most important processes (information flows and decision-making processes in the enterprise) may be illustrated with the help of a flow chart. Operational activities and processes require clear structuring. However, in spite of all necessary formal procedures and elements of organizational hierarchy the employees should be allowed a certain flexibility and creative space.

Many enterprises do not have an explicit structural organization at the beginning of their business activity. In the case of larger start-up projects it is however recommended to create an organization structure at an early stage and to unequivocally assign competences and responsibility areas. This is to prepare for the planned growth in scale and size of the enterprise which will demand a minimum level of division of labour. Moreover, when the enterprise grows, the organization also changes, for the organization structure of an enterprise is after all not a static but a living entity, which must be regularly reviewed for its effectiveness and efficiency [Stutely (2002)]. In addition to a purely functional organization structure, there is, for instance, also the possibility to divide enterprises according to regions or business areas (divisional organization). Within the divisions additional functional structures are often subsequently integrated.

For devising and presenting an effective organizational structure for the new enterprise in the business plan, the following questions can be relevant:

- Which organization structure facilitates a goal-oriented working?
- Is there a comprehensible organigram that can be reproduced and communicated in the business plan?
- Does the planned organization structure allow a goal-oriented management of the enterprise?
- How are changes in the organization structure anticipated and planned?

### 3.1.2.5 Marketing and Distribution

**Marketing Planning**
Potential external investors of the new enterprise consider the marketing plan to be a critical success factor for a start-up. Planning for the market is challenging for new enterprises because they lack established customer relationships and brand names as well as routines to address their target market [Morris et al. (2002b)]. The marketing plan should explain with which strategies and policies customers are to be acquired and how sales revenues and profits are to be generated. The basis of marketing planning is relevant information about the market (e.g., customer characteristics, volumes of market segments, existing products and services, competitive strategies etc.). Marketing aims to be stated in the marketing plan, e.g., the planned level of sales in the first years of business and the market share to be obtained, are defined in coordination with the overall enterprise aims.

Accordingly, marketing planning comprises all marketing aims as well as strategies and policies (e.g., communication and pricing) for achieving the objectives set by the founders. In strategic marketing planning the aims are laid down for a planning period of four to five years. The necessary resources and measures are combined in various ways over time to reach these aims. In contrast, operational marketing planning is shorter, comprising a planning horizon of up to one year. While the purpose of strategic marketing is to gain knowledge of the markets and products as well as to choose suitable strategies, in operational marketing planning measures for an active market development are formulated.

Strategic marketing planning deals in particular with four basic questions:

- In which line of business or industry does the enterprise operate?
- What are the target segments/customers of the enterprise?
- What products and services do the customers buy and how is their willingness to pay?
- How should the enterprise's product and service offers be positioned in terms of branding, communication, distribution and pricing?

From a strategic point of view, the market entry and growth strategies of an enterprise are important. For a start-up business, the **determination of a suitable market entry strategy** is of primary importance. The necessary marketing expenditures are often underestimated, as is the establishment of brands. This does not only apply to the home market, but also to the planned entry into international markets. In this context, it is necessary to determine critical internal and external influencing factors which go into marketing planning and to prepare carefully the planned market entry [Hisrich/Peters (2002)]. Depending on the purpose of the enterprise, the market entry via testimonial customers can be advisable. Their assessments and evaluations can then serve to signal reputation and build trust and help to acquire new customers.

Furthermore, marketing is usually grounded on four essential tools **("the four P's")**, the combination and employment of which must be decided by the founders:

- Product and service policy (product)
- Distribution/sales policy (placement)
- Communication policy (promotion)
- Price policy (price)

The decisive factor is not the optimizing of each individual tool but the purposeful combination of the marketing tools *(marketing-mix)* as a whole.

**Product and Service Policy**

Products and services offered are of crucial importance within the framework of the business plan. The central task of developing a product policy for start-up enterprises is to introduce new products in the market (product innovation), or to modify products which are already on the market (product variation). In principle, the features of the products (quality, functions etc.), design and packaging are to be determined at this point. Of special interest for investors is the question whether the products are patented products or brand products with protected trademarks. It is also important what customer service is offered. Due to the continuously increasing competition intensity and the fast changes of markets, customer service has become an important instrument in the development of effective product policies. Consequently, additional service offers (service augmentation) can be a decisive factor in determining the purchasing decision of potential customers.

**Distribution/Sales Policy**

The distribution or sales policy comprises measures by which products and services are brought to customers. The main question to be addressed is the evaluation of effective distribution channels to reach customers and the costs associated with alternative distribution options. The founders have to decide whether they want to choose a direct or indirect distribution route. The distribution can take place indirectly via a wholesaler or retailer. This may be convenient for a new enterprise because no own sales and distribution structure has to be built. However, there may also be arguments in favour of direct distribution. For example, the computer enterprise *Dell* has so far been very successful in deciding in favour of a direct distribution route to the customer, thus achieving a significant competitive edge. Generally, direct distribution allows offering customers specific benefits in terms of delivery, pricing or product choice. Beyond this, the direct relationship with customers may also offer scope for learning about the target group. The decision about the distribution channel is closely connected with the question of how to organize distribution. Shall an own field sales service be employed or shall the distribution be carried out via a commercial or travelling agent? Can a franchising system be a reasonable alternative? Such questions are of fundamental importance for building up an adequate distribution system.

**Communication Policy**

Communication policy serves to create a suitable product or service positioning in the mind of consumers, including brand recognition, interest and willingness to buy amongst target customers. A good communication strategy can in addition be used by founders to build up contacts and relationships with other important network partners (e.g., suppliers, potential employees, media etc.) as a part of their overall relationship marketing with stakeholders.

Essential tools of communication policy are advertising, public relations work, sales promotion as well as trade-fairs and exhibitions. In addition, event marketing and sponsoring are becoming increasingly important. These two latter forms are, however, in principle not suitable for new and small businesses, but rather for young growing or established enterprises. The decision about the employment of communication tools depends on the available advertising and marketing budget. Advertising allows to reach and inform potential customers directly. However some instruments may be too expensive for start-ups. Typical advertising vehicles are, for instance, television and radio spots, ads in daily news papers and magazines, direct mailing, as well as banner promotion, pop-ups, adwords and interstitials or prestitials on the internet. Advertising, in particular television advertising, is usually expensive and not feasible for young enterprises. In general, founders must see the advertising means to be employed in relation to the aspired promotion effects. Therefore, integrated *media planning* beyond individual advertising carriers (television, radio, internet etc.) makes sense. One should try to reach the target groups in order to achieve a high advertising effectiveness and avoid costly wasted audiences (i.e., paying for advertising audiences which do not belong to the target group of the start-up). To get an idea of the nature of advertising impacts, the so-called AIDA-formula describes the different elements of advertising effects. According to this formula, the primary task is to gain the attention of the customers (attention) and wake their interest (interest). As a next step, the wish to buy (desire) must be generated. Finally the customers are to be motivated to make a purchase (action) [see media planning chapter 4.2.6].

Under the perspectives of costs, public relations work can be a recommended measure, especially for enterprise founders. With the help of press releases and public relations work, the opportunity to present oneself in a favourable light, to build up a positive image and to win the trust of the customers (and other stakeholders like investors) can be exploited in a cost-efficient way. This work may include the publication of newspaper and magazine articles and the organization of symposiums and lectures. Measures of sales promotion can include giving presents, limited offers, product demonstrations and the distribution of vouchers. In practice, advertising measures are often combined with the tools of sales promotion. Trade-fairs and exhibitions are often effective means for introducing the new enterprise to the group of potential target customers.

**Price Policy**

A special challenge is the decision about the prices of the offered products and services. It requires knowledge of the price sensitivity of consumers as well as the cost structures and price policies of the competitors. Depending on the chosen price policy, methods for establishing the price can be divided into the following categories:

- Demand-oriented pricing
  (price acceptance of the customer, level of customer benefit)
- Cost-oriented pricing (calculation method, cost calculation)
- Competition-oriented pricing (price policy of competitors)

In addition, there is the method of **value-based pricing**, according to which the *price is oriented on usefulness and added value for the customer.* In practice, aspects of demand, costs and competition are usually taken into account when pricing a product or a service (e.g., in target pricing). As part of pricing, enterprise founders must also decide on discount, payment, and sales financing policies, all of which may be important tools in fine-tuning the overall price policy and winning customers.

The concluding questions are designed to contribute to the structuring of product and service, distribution/sales, communication as well as price policies:

*Product policy*

- Which products or services (problem solutions) are offered to customers?
- What properties (e.g., quality, design, after-sales service, guarantees) shall the offered products and services have in order to fulfil the needs of the customers?
- What should the range of products be and how shall it be built up?

*Distribution, sales policy*

- How will the product be brought to the customer?
- Which distribution channels (direct, indirect) shall be chosen?
- How should the distribution be supported?
- How must logistics be arranged and what costs are planned for it?

*Communication policy*

- Which measures and tools are adequate in order to communicate the advantages of products and services to the customers in order to generate their willingness to buy?
- What should the budget for advertising and other elements of the communication policy be over the next three years?

*Price policy*

- What is the pricing of the products and services and which price policy is followed?
- How are the prices of products/services determined?
- Are there fixed prices for commercial representatives, wholesalers etc.?
- What sales conditions (discounts, payment terms etc.) shall be granted to customers?

#### 3.1.2.6 Procurement and Production

The extent to which the founders deal with aspects of procurement and production in the business plan depends on the importance of these areas for the start-up project. When founding a growth-oriented industrial enterprise, details of procurement and production strategies can be of interest to investors. For this reason, it should be explained how these strategies will contribute to the success of the enterprise. Depending on the objectives of a company, purchasing, procurement channels and prices can have a lasting influence on profitability. Numerous enterprises with a strong growth have proved in the past that “the profit can lie in purchasing”. In trade, for example, the very successful supplier strategy and the strong negotiating power of *Aldi* have contributed to the result that the enterprise has been achieving above-average profit margins compared to its competitors. Therefore, not only the sales market, but also the purchasing market is important. The significance of the purchasing function in management is, however, often underestimated in practice. Knowing the suppliers and their product offers can bring real advantages for new enterprises.

There are relationships with suppliers in any enterprise, but with varying interdependences. If the dependences on certain suppliers are strong in an enterprise, this must be explained in the business plan. In principle it is important to avoid supplier dependences and to always have suitable alternatives at one's disposal. Procurement risks and their handling as a rule require an explanation in the business plan. In this context, the following questions may be addressed:

- How large is the number of suppliers?
- Who are the most important or suitable suppliers?
- What dependences on suppliers can occur?
- What is the quality of the suppliers' offers, the ratio of price to performance and what are the delivery terms, methods of payment and specific customer services offered?
- What possibilities exist for entering purchasing co-operations?
- Are there any exclusive contracts of suppliers with competitors?

As regards the production process, it must be stated whether it is an in-house or external production. In-house production is usually associated with high fixed costs. On the other hand, external production contains risks in the dependency on the suppliers and the transfer of know-how to external enterprises. The advantages and disadvantages of internal and external production have to be carefully weighed against each other when taking "make or buy" decisions. Possible high investments in production plants, equipment, required personnel and material expenditure should be discussed. Competition advantages have to be considered which might be engendered by lower-cost production processes. The advantages of an in-house production must be clearly stated and should be demarcated against external production on the basis of a comparison calculation and possible strategic implications. If the manufacturing process is of special significance for the enterprise, it must be specified which production type is employed: *single, batch, or mass production.* Production risks, which can, for instance, arise in the form of environmental protection charges, should be represented in the business plan and measures for their handling or avoidance shown.

If subcontractors are involved in the production process, their role is to be discussed. In the production process, the following questions can be relevant:

- What does the production process look like?

- What quantities are to be produced and how does this correspond to planned sales volumes?
- What production resources are required?
- What are the production risks?
- How high is the share of outside components and capital goods?
- What production capacities and level of capacity utilization are planned?

#### 3.1.2.7 Financial Plan and Financing

The financial plan is the central component of a business plan. It is read very carefully by potential investors, usually following the executive summary and the section on the founders or management. The figures of the financial plan reflect the individual plans of the start-up such as, for instance, procurement, production and sales plans in quantitative terms. This means that the financial planning is very complex and that its quality depends primarily on the other subordinate plans as well as on the fundamental assumptions made by the founder(s). In order to reduce this complexity, the following representations are intentionally kept simple. If, in practice, special questions should arise whilst preparing the business plan, which relate to financial planning, it is recommended to take expert advice from tax consultants, auditors or enterprise consultants.

Financial planning allows a detailed insight into the anticipated future financial development of the new enterprise. It can be examined whether the business project can be financed and whether it has good prospects to be profitable in the future. There are several **software solutions** available on the market which may be useful for founders, both for *financial planning* as well as for *the development of a business* plan. [e.g., Business Plan Pro/PaloAltoSoftware; www.paloalto.com; also see www.bpplans.com or www.planware.org] In some individual cases the software packages also contain an integrated (risk) controlling tool to be used throughout the establishment and development of the enterprise.

For the initial financial plan as a part of the business plan, it is usually sufficient to plan for the next *three to five years.* Alternative cases (e.g., best case, base case and worst case) can sometimes be appropriate which allow the construction of different possible developments or scenarios, in particular to analyse the conditions for the business to become and stay profitable. With the help of financial planning, potential financial risks of the start-up project can be detected at an early stage and made transparent. The assumptions for the calculations and forecasts should be substantiated in the text of the financial plan. Against the background of the regulations of Basle II and the associated requirements for enterprises, credit institutes in particular focus their attention on the financial planning [for Basle II see chapter 6.4.3.2].

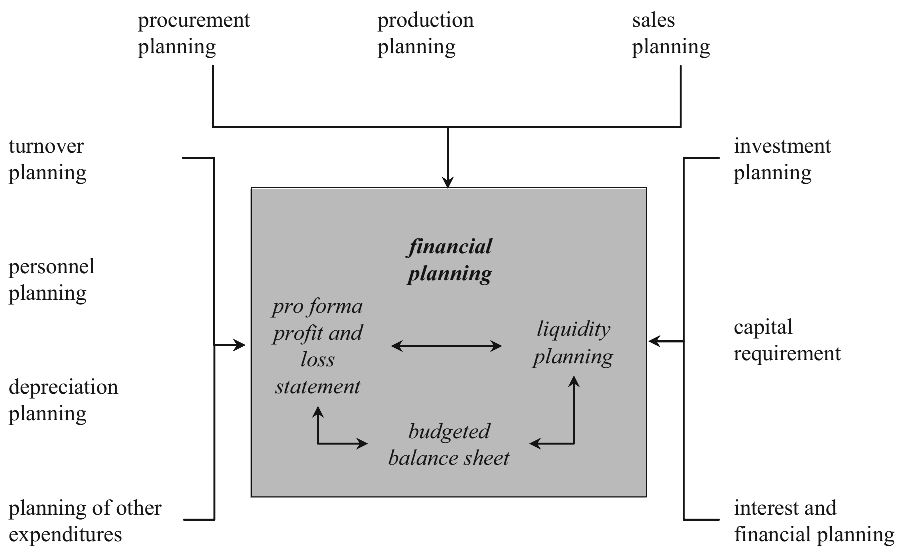
Essential sub-plans of the financial planning are:

- Liquidity planning (cash budget)
- Pro forma income statement or profit and loss account
- Pro forma balance sheet (if required)

For founders it will be a particular challenge to estimate future sales revenues and costs and to derive the anticipated operating income. The further ahead into the future plans reach, the greater is of course the uncertainty and vagueness of planning. For this reason, plans are often made monthly only for the first business year, quarterly for the second year, half-yearly for the third and for the last two years only annually.

Illustration 3-7 shows interdependencies of basic components of a financial plan.

***Illustration 3-7:*** *Interdependencies of basic components of a financial plan*




When drawing up a financial plan several mistakes can be made. These range from an incomplete or false data and information base to unrealistic planning calculations. In practice it is therefore recommended to consult expert knowledge when drawing up the financial plan. In addition to a well-founded financial plan, the employment of controlling and managerial accounting tools for the planning, allocation and control of financial resources is an important precondition for the sustained success of the future development of the new enterprise.

**Liquidity Plan (Cash Budget)**
Liquidity planning means to keep track of the relevant payment flows (in-payments and out-payments) which are set against each other; i.e., a liquidity plan or cash budget is cash-based rather than accruals-based [Timmons/Spinelli (2004)]. This cash-based approach is essential since, in principle, an enterprise must at any time be able to fulfil its payment obligations in due time. Put in simple terms, liquidity means that there is always enough money on the account of the new enterprise. Thus the liquidity plan (cash budget) is the heart of financial planning. In-payment and out-payment items (or cash in- and outflows) must be taken into account, both for the regular business as well as for capital expenditure items. The liquidity plan (cash budget) reflects the solvency of an enterprise. In order to avoid insolvency or illiquidity, it must always be possible to settle invoices and other obligations. With regard to projected cash outflows (including capital expenditure, e.g., investments in machinery), special attention should be given to establishing the monthly peak in liquidity demand. In the case of a shortage, the difference must be covered by personal liquidity or the liquidity of external financiers, for example, through credit lines of credit institutes or external equity investments. One should, however, bear in mind that in the case of difficulties the credit lines of the enterprise can be suspended or cancelled at short notice. Table 3-1 shows an example of a liquidity plan (cash budget) for one year, in which the in-payment items from sales and the out-payment items, e.g., for personnel and materials, are listed. This plan does not lay claim to completeness, other forms and structures are conceivable. An item which is difficult to plan is sales revenues, which should only be included when the expected payments have actually been received. In face of the continuously sinking payment morale of customers, which has been observed over the last few years, time delays have to be included into the calculations until the outstanding bills have been paid. To simplify matters, the out-payments can be derived from the profit planning (e.g., a pro forma profit and loss or income statement) with the exception of depreciations. The depreciations are not taken into consideration, as they do not influence the liquidity of an enterprise (this is one of the main differences between accruals-based and cash-based accounting). Personnel costs, material consumption, interests on external capital and outside investments affect the liquidity and must be included as out-payment items.

Unforeseen liquidity bottlenecks or surprising illiquidity can lead to insolvency of the enterprise. This situation can be caused by many factors, e.g., through the unforeseen cancellation of planned orders, through inadequate planning of capital requirements or through a wrong assessment of the market and customer potential. Important questions to ask in connection with the planning of liquidity are, for instance:

- What out-payments and in-payments will be necessary in the first few years?
- Have delays in in-payments due to payment respites and payment habits of the customers been taken into consideration?
- Have possible claim losses been taken into consideration?
- What shortage or excess coverage can be deduced from the liquidity planning?

*Table 3-1: Example of the structure of a cash budget*

| Item | | Jan. | Feb. | March | […] |
|---|---|---|---|---|---|
| 1 | +/- initial cash balance | | | | |
| 2 | + credit bank balance | | | | |
| 3 | ***= sum of liquid funds (sum, item 1 and 2)*** | | | | |
| 4 | + sales revenue | | | | |
| 5 | + (partners) loan | | | | |
| 6 | + private contribution to capital | | | | |
| 7 | + paid-in interests | | | | |
| 8 | + other payments-in | | | | |
| 9 | ***= sum of cash-inflows (sum, items 4 to 8)*** | | | | |
| 10 | = ***liquid funds availabl (sum, items 3 and 9)*** | | | | |
| 11 | - wages/salaries | | | | |
| 12 | - social security contributions | | | | |
| 13 | - goods | | | | |
| 14 | - rents | | | | |
| 15 | - administration | | | | |
| 16 | - distribution | | | | |
| 17 | - taxes | | | | |
| 18 | - insurances | | | | |
| 19 | - interests | | | | |
| 20 | - depreciation | | | | |
| 21 | - other payments-out | | | | |
| 22 | - investments | | | | |
| 23 | - personal drawings | | | | |
| 24 | ***= sum of cash outflows (sum, items 11 to 23)*** | | | | |
| 25 | ***Excess/shortage cover (diff. 10 and 24)*** | | | | |

**Pro Forma Income Statement (Planned Profit-and-Loss Calculation)**

Pro forma income statements (or projected profit and loss accounts) are a device with which the anticipated result (profit, loss) of an enterprise is planned for specific time periods. Within this framework, the expected operating result and subsequently the annual result (annual profit or loss) are calculated step-by-step. Often, entrepreneurs will use the respective country-specific format of a profit and loss account or income statement for established companies. The critical and difficult part of financial planning is the development of a **sales (or revenue/turnover) plan**, which is derived from forecasted sales volumes and prices. In most cases it is not known in the pre-founding planning period or at start-up when the business plan is prepared, how many customers will buy the offered products or services and at what prices. Turnover planning becomes particularly difficult if there are no relevant comparative figures from the specific business sector available which may be used as proxies. At this point, scenario planning is required under certain assumptions, and in practice a minimum turnover and a maximum possible turnover are often planned (e.g., worst-case and best-case scenarios). In this case, the turnover which can be achieved as a maximum is calculated, given the available or planned capacity. The actual turnover to be pencilled into the business plan could then move between these obtained basic values. Such an approach will, however, require certain prudence. It is especially important to remain realistic. If it is not possible even in the planning phase to reach the minimum turnover required to cover costs and reach break even, the realization of the whole enterprise project should be fundamentally reconsidered.

Often enterprise founders are of the opinion that a turnover-estimation is not possible. They are confident that there will be a sufficient number of customers who will buy their products or services. However, such an attitude would be looked upon highly critically by potential investors. In particular, in competition-intensive business sectors and those with short product life-cycles, the aspect of a possible (fast) dip in prices is to be taken into consideration, which may lead to a decrease in the gross profit from sales. For example, this may happen to new enterprises in the computer or hardware manufacturing industry or those operating a trade business.

The calculation of scheduled sales prices forming the basis for turnover planning can be carried out in different ways. Two parameters, however, are to be considered in particular:

- The calculated price which must be obtained as a minimum in order to be profitable and
- the market price which can be achieved given the demand and competition situation.

Multiplying the determined price by the expected sales quantity (per time unit, e.g., month) gives the turnover or sales revenues in the profit-and-loss-account. Sales revenues are revenues from the sales of products and services as well as from lettings and leases after revenue reductions and sales tax have been taken off. Revenue reductions reflect reductions of the sales price in case of faulty products or services.

When determining the sum of the earnings, the sales revenues, the changes in stock, the company-produced additions to plant and equipment, and other operational returns are to be taken into account. The increases in stock are finished or half-finished goods, which were manufactured but not yet sold in the accounting period. They lead to an increase in the total performance. The decrease in stock comprises goods which were manufactured before the accounting period, but only sold during this period, and reduce the total performance. Under the concept of **company-produced additions to plant and equipment** *products and services* are summarized *which the enterprise manufactures for itself*, e.g., tools which otherwise would have to be bought. **Other operational returns** are derived, for instance, from *book profits for the sale of machines, plant and buildings*, the *dissolution of no longer required reserves*, *tax refunds* as well as other *interests* etc. In the case of newly founded enterprises, planning with regard to extraordinary returns and expenditures can be neglected, i.e., returns and expenditures outside the normal business activities.

An essential factor, in particular for personnel intensive start-ups, is the planning of the personnel expenses. Starting with the personnel requirement plan, the regular shop-floor wages, office salaries and other payments, such as holiday and Christmas money or allowances and pay-rises, have to be calculated according to quantity and date, and must be explained to potential investors. Added to these payments there may be auxiliary personnel costs, e.g., employers' contributions to national insurance etc.; such auxiliary expenses will depend on the specific labour market legislation of the country in which the enterprise is operating. When calculating possible auxiliary personnel costs, employers' contributions are in practice often calculated with a flat sum added to the gross income for reasons of simplicity.

The planning of **depreciations** is also of special importance. Depreciations are *value reductions of operational economic assets* (machinery, vehicles, office furniture, computers, etc.) in order to account for the limited useful-life assets. There are typically a number of main depreciation methods, which are allowed by tax authorities, most often *straight line* and *reducing balance depreciation*. While country-specific accounting rules may vary, often legislators have fixed a standard useful operational life (on which depreciation calculations will have to be based) for the different economic assets.

In summation, the following questions will be relevant for generating financial exhibits and a pro forma income statement in particular:

- How will turnover, costs and returns develop over the next three to five years?
- What do the various alternative plans (best, base, worst case) look like?
- Which indicators or proxies are obtained for turnover figures and costs per new customer, customer groups, product and product groups?

- What are the specific assumptions made by the founder(s) behind the planned income statements (and other financial exhibits) in the business plan, in particular in terms of estimated productivity, economic efficiency and resulting profitability?
- Which special economic opportunities and risks do exist?

An example structure for a pro forma income statement is presented in the following tables. Note that accounting standards for new enterprises may depend on the legal form of the business as well on the country where the enterprise is domiciled. [The structure of the first statement (I) shown in Table 3-2 is geared to German accounting rules, while the second (II) presented in Table 3-3 is more geared towards the Anglo-American, in this case UK, accounting jurisdiction (II); other formats can be found, e.g., in Timmons/Spinelli (2004) who use a structure displaying net sales, operating expenses, other income (expenses), income taxes to arrive at a net income figure.]

***Table 3-2:*** *Example of the structure of a pro forma income statement (I)*

| | Designation | 200w | 200x | 200y | 200z |
|---|---|---|---|---|---|
| + | *Sales revenues** | | | | |
| +/- | *Stock changes** | | | | |
| + | *Company-produced additions to plant and equipment ** | | | | |
| + | *Other operational returns (rents, commissions)* | | | | |
| = | **Overall operating performance** | | | | |
| - | *Material expenses**<br>(raw materials and supplies, goods, discounts etc.) | | | | |
| = | **Gross return** | | | | |
| - | *Personnel expenditure**<br>(wages, salaries, social security contributions, extra payments) | | | | |
| - | Depreciations* (tangible assets, intangible assets) | | | | |
| - | Other operational *expenses**<br>(costs for premises, insurances, vehicle costs, tele-communication, travelling expenses, promotion costs, office requirements etc.) | | | | |
| = | **Operating result** | | | | |
| + | Incomes from investments and shares** | | | | |

| | Designation | 200w | 200x | 200y | 200z |
|---|---|---|---|---|---|
| + | Incomes from other securities** | | | | |
| + | Other interests or similar incomes** | | | | |
| - | Amortizations on investments** | | | | |
| - | Interests and similar *expenses*** | | | | |
| = | **Financial result**** | | | | |
| = | **Result of usual business activity (operation and finance result)** | | | | |
| + | Extraordinary revenues* | | | | |
| - | Extraordinary *expenses** | | | | |
| = | **Extraordinary result** | | | | |
| - | Taxes from income and profits* | | | | |
| - | Other taxes* | | | | |
| = | ***annual surplus/annual deficit*** | | | | |

* to be listed as individual items either as a separate section within the sales plan (indicating the costs of sales) or as separate operational budgets.

** Normally not applicable to newly founded enterprises. More relevant for established, possibly young enterprises.

*Table 3-3: Example of the structure of a pro forma income statement (II)*

| | | 200w | 200x | 200y | 200z |
|---|---|---|---|---|---|
| + | *Net Sales* (opening stock-closing stock*)* | | | | |
| - | *Cost of Sales* (manufacturing costs and expenses) | | | | |
| = | ***Gross Profit*** | | | | |
| - | *Selling and Distribution Costs* (e.g., salaries of salespersons; general distribution costs) | | | | |
| - | *Administration expenses* (administration wages and salaries; general administration expenses etc.) | | | | |
| = | ***Operating income before tax*** | | | | |
| + | Other income (e.g.,+ rents receivable) | | | | |
| - | Other expenses (e.g., – debenture interest) | | | | |
| = | **Net profit before tax** | | | | |
| - | Corporate tax | | | | |
| = | **Net profit after tax** | | | | |

Often details concerning the asset (and capital) structure of a new enterprise are only of small significance to readers and deciders of start-up business plans (while becoming more important for large established companies). However, in particular in the case of capital-intensive new enterprises (e.g., in manufacturing) which budget for substantial investment plans, potential investors are interested in the **budgeted balance sheet.** This gives a survey of the planned financial position and capital situation of the new enterprise during the development phase to come. In particular, budgeted balance sheets indicate how planned business operations (and the, in particular long-term, assets necessary for these) correspond to the proposed financing structure of short-term liabilities and long-term equity and debt capital which will be available to fund the business. A budgeted balance sheet exhibits all fixed (or long-term) and current assets as well as all financial sources in terms of current and long-term liabilities and the enterprise's equity capital. [See Table 3-4 below; and Timmons/Spinelli (2004) for a US format exhibiting current and long-term assets balancing (current and long-term) liabilities and shareholders' equity.]

*Table 3-4: Structure of a budgeted balance sheet*

| | | 200w | 200x | 200y | 200z |
|---|---|---|---|---|---|
| + | **Fixed assets (e.g.,)** | | | | |
| | Plant and machinery | | | | |
| | Motor vehicles | | | | |
| + | **Current assets (e.g.,)** | | | | |
| | Stocks | | | | |
| | Debtor accounts receivable | | | | |
| | Cash and bank account | | | | |
| = | **(Total Assets)** | | | | |
| - | **Current liabilities (e.g.,)** | | | | |
| | Creditor accounts payable | | | | |
| | …Short-term bank credit | | | | |
| - | **Long-term liabilities (e.g.,)** | | | | |
| - | Long-term credit (private; bank) | | | | |
| | (financed by) **Shareholders' capital** | | | | |
| = | **(Total liabilities and shareholders' capital)** | | | | |

**Capital Requirement and Financial Planning**

In addition to the existing personal resources of the enterprise founders, borrowed funds from credit institutes or additional external equity financing from business angels or venture capital companies are usually required, in particular for growth-oriented high-technology start-ups. Investors and lenders will only provide funding if the start-up project offers good prospects and promises sustained profit-making. The relevant tool for determining and communicating the anticipated profit of the venture project is the profit planning described above which presents a pro forma income statement for the start-up business from which its potential profitability can be deduced.

*Capital Requirement*

The purpose and volume of external capital required are of special interest for an enterprise as is the time horizon for which the funds will be needed. Initial **capital requirements** usually emerge from needs to fund production and other long-term operational facilities (plant and equipment) and short-term working assets. In addition, one-off foundation and start-up costs will have to be covered until the first payment is received from the sale of products or services and financing from internal cash flows becomes possible. The actual requirement for capital can be derived from the liquidity plan (cash budget). The total capital requirement is deduced from what, when and how many financial resources are required in terms of peak demand for liquidity. The capital requirement of the start-up is to be planned in such a way that the profitability is secured and the solvency is guaranteed at any time. Therefore the capital requirement must not be rated too low, but neither too high.

As a first step, the capital requirement for the operational assets and their purchasing costs should be established. This is done within investment or capital expenditure planning. It is recommended to draw up an investment plan, into which the purchasing price and the auxiliary costs for all capital expenditure items are to be included. After the investment plan and the out-payments for investments, the depreciations and resulting book-values of the economic assets are to be listed in additional tables. In doing so, not only the fixed assets to be acquired, but also the existing fixed assets must be taken into account. The items of the long-term assets (in particular plant and equipment) and working assets, which have been determined in the investment plan, are taken over into the capital requirement plan. In the context of capital requirement planning, the following questions can help to structure the plan:

- How large is the capital requirement which can be derived from the liquidity plan (cash budget) for the start-up?
- How much personal equity capital from the founders will be invested in the start-up?
- To what extent shall the capital requirement be covered by equity capital (external investors or personal self-financing by the founders) or debt capital (e.g., bank loans)?
- Is it possible to tap public sources of funding from public enterprise policy (e.g., public loans to small businesses)?
- What is the expected return for investors and will the start-up enterprise be able to meet those demands?

In the case of a planned engagement of business angels or venture capital companies, the exit possibilities preferred by the enterprise founders are to be discussed because these types of investors will provide funding for a limited period of time and then sell their investments (exiting).

*Financing*

In the financing plan, the origin of the resources is presented. It is shown what financial resources are necessary to meet the established capital requirement. In addition, the external equity and debt sources are to be listed in the financing plan to obtain a comprehensive and complete picture of the financing project. It is essential that liquidity bottlenecks are avoided. The financing plan therefore gives an overview of the origin of the required capital and shows the capital structure of the planned start-up project with regard to the ratio of debt to equity capital. In principle, many financing sources are available to founders of new enterprises. These range from personal resources of the founders to business angels, venture capitalists, bank loans and public development loans. Potential questions in the context of financing are, for instance:

- What is the ratio of equity to debt capital, i.e., what will the desired capital structure of the business be?
- What financing instruments are obtainable?
- What are the sources of financing to be used?

### 3.1.2.8 Opportunities and Risks

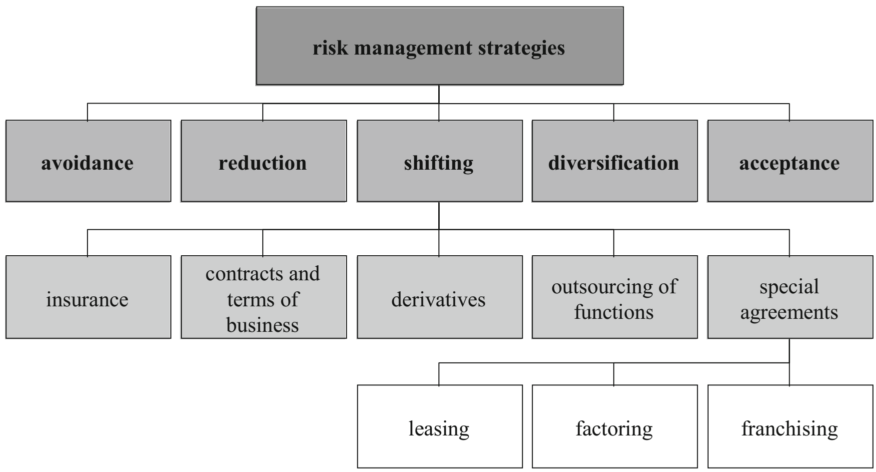
In the case of start-up enterprises, the uncertainties with regard to success are particularly high and failure rates are substantial [Aldrich (1999)]. In order to win the confidence of investors, it is necessary to present openly the recognized risks. By describing the risks, the founders show that they have thought through their venture project and that they proceed with commitment, but also realism. It is essential to list not only the recognized risks, but to also show how they will be dealt with. It must, for instance, become clear how latent or existent risks in the product development process are to be made manageable. In addition, the particular opportunities of the start-up are to be listed. The opportunities can lie, for instance, in an innovative product or a cost-saving distribution channel. It is important that the listed opportunities are transparent and seem realistic to a potential investor.

In this context it is also to be examined in how far planning, in particular the financial plan and reported demand for capital, leaves some leeway upwards and downwards. As already mentioned in the chapter on financial planning, it can be useful to create various alternatives for scenarios from *best case, base case* and *worst case,* into which the most important parameters are integrated. The parameters can be of qualitative or quantitative nature, and their result can be summarized in an opportunity-risk-profile [Ludewig (1999)].

Quantitative factors and changes can influence the financial position of the enterprise and financing planning in many ways. With the help of a computer-aided sensitivity analysis it can, for instance, be determined how turnover increases or decreases will affect the calculated profit or point in time when break even may be reached. Qualitatively, the developments within the enterprise (e.g., deficits in the management team or delays in the product development) and outside the enterprise (e.g., weakening economic conditions or increase in competition) are taken into account.

There are several **risk management strategies** available which can be applied as strategic management tools in the context of entrepreneurship. At first stage it is possible for a young enterprise to choose a risk management strategy of avoidance, reduction, shifting, diversification or acceptance. Illustration 3-8 gives an overview of different risk management strategies which may be employed by entrepreneurs. Note that the different strategies involve different ways to go about handling the risks perceived by entrepreneurial management. Sometimes risks can be avoided straight away or at least reduced (e.g., operational risks like production failures may be addressed by adjusting the manufacturing technology employed). Other risks may be diversified away (e.g., the dependence on a specific supplier by broadening once supplier base) or shifted to and shared with others. The latter is a typical strategy to modify risks through instruments like insurance, contracting, or outsourcing.

***Illustration 3-8:*** *Risk management strategies*




The answers to the following guiding questions will essentially lead to an analysis of the opportunities and risks:

- Which specific opportunities and risks do exist for the planned venture project (e.g., with regard to product developments, customers, competition, suppliers)?
- What measures are planned to reduce or avoid the recognized threats?
- Which quantitative and qualitative variables will have a special influence on the future enterprise development?
- What is the “best-case” and the “worst-case” from the point of view of the financial planning for the next three planned years?

### 3.1.2.9 Appendices

Appendices offer room for anything that is too detailed for the actual business plan but is essential (informative) for the reader. This can include:

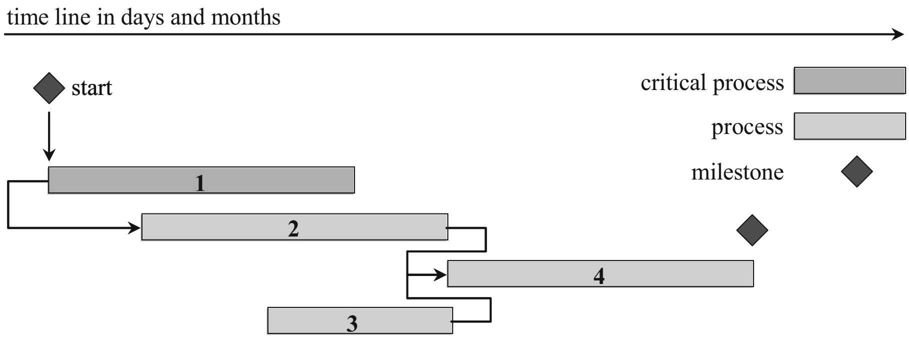
- Curricula vitae of the founders
- References
- Company agreement or possibly an extract from the Register of Companies
- Contracts (licences, purchasing, letting, lease, letter of intent etc.)
- Organigrams
- Technical detailed drawings
- Press releases
- Detailed planning calculations (ancillary calculations)
- Patents
- Official authorizations
- Time and realization plan

It is essential that the annexes do not become a “data cemetery” but contain, above all, additional data and information for the interested reader. The business plan should also be comprehensible without the appendices, with existing important contracts with customers, suppliers, licensers etc., being dealt with in the main part of the business plan. In addition, copies of important contracts should be attached in an appendix so that the investors can gather a comprehensive picture. In the time and realization schedule for the planned start-up enterprise, the necessary milestones for its realization must be systematically recorded. Tasks, responsibilities and test criteria should be laid down in detail, taking into account the planned time horizon. Elements in the near future should also be described in detail, for milestones in the coming years a rough description will suffice.

**Given the importance of the time and realization plan** for new venture projects, it can also be seen as an *integral component of the main part of the business plan.* This is especially the case if external investors play a role in the planned project, as it is important for investors to be able to recognize quickly the time required for the individual activities and development steps. For the founders, it is always important to keep these initial milestones in mind. There is the danger that in the appendices, the time and realization plan is not given sufficient attention by the founders.

The time and realization plan can also be shown graphically in a Gantt-diagram. Illustration 3-9 shows an example of a Gantt-diagram layout.

*Illustration 3-9: Gantt-diagram of time and realization plan*




| *no.* | *name of process* | *duration* | *start* | *end* | *precursor* |
|---|---|---|---|---|---|
| 1 | market research | 14 days | | | - |
| 2 | preparation research | 14 days | | | 1 |
| 3 | target formation | 8 days | | | - |
| 4 | strategy development | 16 days | | | 2, 3 |

In a Gantt diagram, individual processes are planned in relation to each other. Their representation uses bars, the length of which represents the duration of one process. Dependences or processes that follow each other or build on each other are connected by arrows. In addition, realization plans are characterized by milestones designed to reflect essential, pre-defined events at certain dates in the planning of the future development of the start-up enterprise. The planning should not be limited to the form of a graphic representation. Process name and duration, starting and end times, as well as the relationship between the processes, are to be shown in the form of tables. As a rule, the planning is done with a timeline using days, weeks and months. In principle, the employment of individually adapted time units is also possible. The Gantt-diagram (or comparable planning tools) can help to systematically plan the venture project taking into account success- or time-critical activities or dates. For instance, time deviations for certain processes can be made transparent, and the appropriate measures for counteracting them can be initiated. Various software programs can be used for planning the temporal development of start-up projects, as for example the project planning software *Microsoft Project.* This software available for the Windows-operating system is, however, not cheap and rather complex due to its functional volume. In addition, there are also numerous project planning software programs for the operating systems Windows, Mac OS X or Linux, which are relatively budget-priced or even free.

Examples:

- *Open Workbench* (Windows) [www.openworkbench.org]
- *Plan for Windows* (Windows) [www.twiddlebit.com]
- *iTaskX* (Mac OS X) [www.itaskx.com]
- *Merlin* (Mac OS X) [www.projectwizards.net]
- *Project-open* (Linux) [www.project-open.org]
- *TaskJuggler* (Linux) [www.taskjuggler.org]
- *Planner* (Linux) [www.simpleprojectmanagement.com]

### 3.1.3 Typical Mistakes in Business Plans

The possible mistakes in drawing up a business plan are numerous. In the following, a survey of typical mistakes is presented, as they can often be observed in practice. This overview is designed to serve as a point of departure for designing a check list for one's individual venture project.

**Executive Summary**
A typical mistake made when drawing up the executive summary is *writing a summary that is too long.* The summary should *not to be understood as an introduction to the business plan with references to certain chapters.* Occasionally, it also occurs that the author falls into *excessive enthusiasm* and a *realistic representation based on facts* is neglected. In many cases, a *too technical description of details* is included, which the reader may not be able to comprehend at this point. A *non-existent* or *inadequate description of the benefit of the enterprise's products to the customer* is another fundamental mistake, as this should play a central role in the business plan and the strategy of the enterprise. It is problematic if *the information of the summary is not reflected in the main part* of the business plan, for consistency and clarity of the statements within the plan are essential. This rule also applies to the plan data. Problems will arise when the financial requirements, *turnover volume or expected returns are unclear,* e.g., if the turnover has not been estimated, but explicit demands for capital have been assessed. Such mistakes, when readily recognizable in the summary, can cause the reader to lose faith in the whole prospectus. It is quite possible that he/she *will no longer be motivated to read the whole of the business plan.*

**The Enterprise, its Products and Services**
It is problematic if the *enterprise objective or the business idea is not transparent* and clearly worked out, or *no statements* are made as to whether *the business model will be economical or profitable.* If *enterprise goals and strategies* are missing or have been formulated inadequately, this indicates that the project has not been well thought through. Any *simulta-*

*neous pursuit of competing aims*, e.g., of leadership in costs and innovations, is usually unconvincing. It is disadvantageous if *no general enterprise strategy is recognizable.* The same applies if growth is in principle the aim of the start-up project, but differentiated *growth strategies,* for example, with regard to products and markets *are lacking* or the *planned strategy is not practicable* with the resources (capital, personnel etc.) that can realistically be acquired. It is also problematic if the *product and service offer in the business plan has not been described in a comprehensible and transparent manner.* Existing or foreseeable *protection rights* (e.g., patents, licences) should certainly be listed. Central mistakes are often made with regard to customers' needs as well. Either *customers' needs are not described* or *no statements are made concerning the benefits of the products or services for the customers.* Often, potential for further development as well as potential risks in the development process are neglected in the explanations.

**Industry, Market and Competition**

*Often, developments and critical factors influencing the industry the enterprise will operate in are* not presented. Further possible mistakes in a business plan are a *missing indication of comparable products* and expected new developments, as well as an *insufficient market and customer segmentation*. Within the business plan, not only the internal factors are significant, but also external influencing factors. It is a typical mistake if the *strengths and weaknesses of competitors are not recognized* and *reactions of competitors to the market entry of the enterprise are not anticipated.* Power and speed of imitators can, for instance, be underestimated. A detailed and purposeful analysis of the competition is important. Often, the *market segments served by the competition are not taken into consideration.*

**Management Team, Personnel and Organization**

It can occur that the *presentation of the relevant experiences and competences of the founder or management team is incomplete or even missing.* This represents a particular disadvantage if the founder team, as a whole or in parts, does not have the competences required for the start-up (e.g., industry experience or management competence). In some cases, essential tasks and responsibilities may not reflect the core competences of the founders.

Qualified employees are valuable resources. Although of central importance, in particular for venture projects oriented towards growth, the *recruitment and binding of employees is often neglected in the business plan,* and *the problems related to finding and keeping qualified employees are therefore underestimated. Measures for continued and further training* can support the recruitment and binding of new employees and should already *be integrated into the business plan*. Finally, it can be a mistake if *no selection and evaluation of future cooperation partners* is made, because often outsourcing will be a valuable strategy to stay cost-efficient and use resources for core value-adding activities.

**Marketing and Distribution**

The customer is the centre of the attention for any start-up enterprise. At the same time, it is important to know how and by which means customers should be addressed. It is therefore a mistake *not to list the communication channels through which the target customers are to be reached.* A long-term relationship with customers should be aimed for and planned measures for customer retention should already be listed in the business plan. A central aspect is the development of a marketing strategy and a purposeful targeting of the marketing tools. Often, business activity is taken up without having formulated a *market entry strategy.* It is also a problem if the employment of *wrong or unsuitable marketing tools is planned.* As regards understanding the business plan, questions may arise if the *marketing budget has not been worked out exactly in sufficient detail, or has been underestimated financially.*

**Procurement and Production**

In the area of procurement and production, a typical mistake is the *disregard of potential risks in production processes.* In addition, the *costs of in-house production* are often underestimated by founders. *Strong dependences* on suppliers can be a problem in the long-term for a new enterprise and, in an extreme case, may even threaten its existence. It is critical if *the network of suppliers* or strategic partners *is not coordinated and quality management and controlling* are not taken into account in order to keep up quality and efficiency in procurement and production.

**Financial Plan and Financing**

The financial plan can be unrealistic if *there are no statements about the founders' managerial assumptions implicit in the planning data.* Very often, *start-up costs and reserves for unforeseen circumstances* in the starting phase of the enterprise are *underestimated.* Another mistake is that *planning assumptions and data in the financial plan* do not match *the qualitative statements in the business plan.* If the founders *did not develop any planning scenarios or alternatives,* quick or adequate reactions at changed conditions are often not possible. It is problematic if the *financial plan has not been drawn up clearly and transparently.* Here the use of suitable planning tools as, for instance, an integrated planning software can be helpful. A typical and sometimes serious mistake is that the *requirement for capital is underestimated.*

**Opportunities and Risks**

In many cases, *the relevant risks* which might threaten a start-up project *are not taken into account* in the chapter about opportunities and risks of a new enterprise. These risks can refer to the market, competition or technological development. In the same way, a *missing quantification and evaluation of individual risks* as well as the *overestimation of opportunities* can be identified *as potential problem areas* in business plans. *The derivation of possible alternative action options* and the formulation of *a strategy,* which secures the survival of the enterprise in the worst case, are reasonable requirements.

**Appendices**
A typical mistake with regard to the compilation of appendices of business plans is that *essential enclosures are missing or incomplete.* Examples are contracts, *curricula vitae* of the founders, patent copies, market studies or the *realization or milestone plan.* A converse danger is that appendices become inaccessible and overburdened with detailed information.

### 3.1.4 Business Plan and Controlling

A thoroughly prepared and sound business plan can be the nucleus for establishing a systematic enterprise planning and controlling, in particular for growth-oriented enterprises. The further development and transformation of the business plan into a continuous planning and controlling system allows the founders to explore both operational and strategic options for action. The controlling system is of varying importance for individual start-up projects depending on their size and growth objectives. For a newly founded small trading business, a simple cost calculation, e.g., using contribution margin accounting, can be adequate, while a high-technology start-up oriented towards rapid growth will already require professional controlling at an early stage. Bearing this in mind, the practical build-up and development of a suitable controlling system must be carried out for each individual case according to its specific needs. In the following section, some important aspects of controlling and managerial accounting tools will be examined with regard to the business plan. The discussion will refer primarily to young, growth-oriented enterprises.

The concept of **controlling** can be defined as the *support of business management in planning, directing and controlling organizations and processes* through a goal-oriented provision of up-to-date internal and external information and data. Controlling has primarily the task of directing the actions of the management of an enterprise towards reaching the overall general enterprise objectives [Hahn/Hungenberg (2001)]. The assistance of business management in making decisions and reaching objectives is of central importance within this context. Controlling therefore goes far beyond an interpretation of the concept as *pure control within the meaning of a target/actual performance comparison.* Depending on the time horizon, strategic controlling can be distinguished from operations management ("operational controlling"). Starting with the general aim of securing the existence of the enterprise in a sustained manner, strategic controlling is geared towards an increase in the market value of the enterprise (market value added) [Bausch/Walter (2002)]. An additional essential aim of controlling consists in *securing the economic efficiency* as well as in *achieving profitability of all operating areas of the enterprise.*

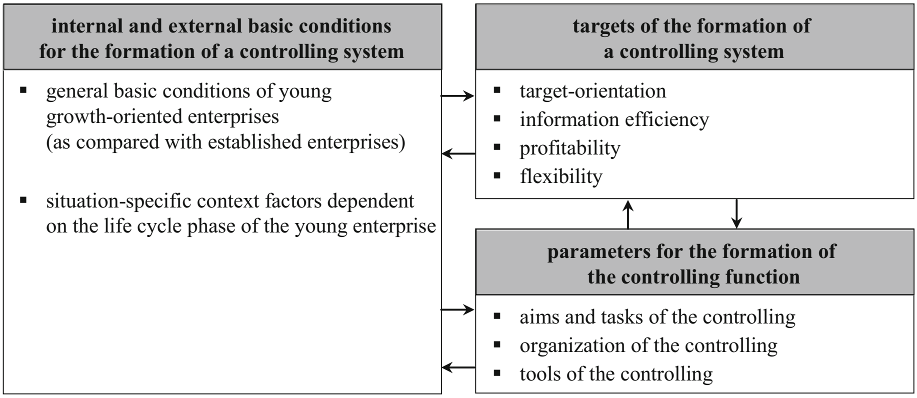
The controlling system structures, coordinates and accompanies the **phases of the goal determination, planning, direction and control** from the procedural point of view (management process), *securing the transparency of strategy, turnover, profit, cost, finance* *and process* in the individual areas of the enterprise. Thus, even during the preparation phase of the business plan, it is important for founders to consider introducing a professional controlling and management accounting system.

One task of controlling is its contribution to the conception of the business plan and the coordination of its part plans, in particular with regard to finance and financing planning [Sahlmann (1997); Bausch/Walter (2002)]. (Potential) investors in particular pay attention to a professional controlling within the context of a regular, standardized reporting system. The *information collected in the business plan for different parts of the enterprise and the external economic environment* can form the basis for establishing an integrated planning, control and information system. In particular, such a system will be valuable in keeping investor relations and meeting the reporting and information needs of external investors [Kollmann/Kuckertz (2006)]. Controlling facilitates process transparency, taking into account specific opportunities and risks, and above all helps the founder management to determine sensible goals and formulate the contents for planning and managing the young enterprise. *Even in the pre-start-up phase* the *business plan* therefore contributes *to determining and achieving the aims* of the enterprise founders [see also Wittenberg (2006)].

The function of the business plan as a tool for structuring, implementing, communication and information does not end with the process of initial start-up planning. The business plan contains fundamental data and information, which can be utilized for building up a controlling system for later development of the enterprise. In the course of preparing the business plan, future actions are mentally structured and anticipated. Through this sometimes very time- and resource-intensive process, a specific and target-oriented knowledge basis is generated for the enterprise. As regards the introduction of a controlling system, it is recommended to transform the business plan into a proper enterprise-planning instrument and to update it continuously. From the operational point of view, on the one hand, target/actual performance comparisons can be carried out, and counteracting measures can be initiated in case of deviations. On the other hand, targets and strategies of the individual planning areas can be adjusted using information generated by the continuous observation of these areas, so that it is possible to react to the changes of different variables. By developing the individual sections of the business plan, and adapting them to changing internal business and external environmental conditions, the phases of goal determination, planning, direction and control may be travelled through in a structured and coordinated way; this managerial process may be gone through repeatedly as the new enterprise and its business unfold over time.

Illustration 3-10 shows a possible reference frame for creating a controlling system according to Bausch/Walter (2002).

*Illustration 3-10: Reference frame for the formation of the controlling function*




From the point of view of organizing the controlling function in a new enterprise (e.g., the position of a controller) this should be located close to the enterprise management or founders (or be in the responsibility of one of the founders). The position of a controller accompanies and forms the above-mentioned management process and contributes to the development and achievement of the enterprise's objectives.

The central tasks of a controller comprise, according to Hahn/Hungenberg (2001); Bausch/Walter (2002); Horvath (2006):

- Coordination of sub-goals and -plans in relation to the overall corporate goals of the enterprise
- Formation, organization and maintenance of reporting systems
- Provision of up-to-date information and data
- Securing effectiveness and efficiency in business operations

In practice, the separation between controlling and enterprise management tasks is fluid. Established enterprises have special positions for controllers who are responsible for the listed tasks. In young enterprises, the question arises whether a specific controller position is already economically feasible. Often, suitable organization structures are still lacking, which would allow an anchoring of the controlling function in the organizational hierarchy of the enterprise. In practice, it is quite usual in the early phases of the enterprise development that the controlling lies in the hands of the founders themselves. When the right moment in the enterprise development has come for establishing an independent controlling function depends on many internal and external factors and cannot be answered sweepingly. In strong-growth enterprises, it is particularly recommended to introduce a controller position at an early stage and to establish a controlling system, which accompanies the founders or the management team and relieves the burden on scarce top-management and entrepreneurial resources. It is sensible if the controlling position is responsible for the complete planning, control and information management. The advantage of a separate controlling position is, therefore, that the burden on the founders is lightened and that the management process is assisted by the analytic and quantitative perspective of a professional controller. A separate controlling function should, however, not be understood as a substitute for the executive staff or the management duties of the founders. It rather acts as a kind of "spotter" for founders in determining goals and preparing decisions. By complementing the perception of the founders, controlling can contribute to avoiding ill-informed or false decisions, as these can in the early phases of the enterprise development very quickly lead to a crisis or even a threat to the existence of the young enterprise. Young enterprises are usually fast and flexible in their reactions to dynamically changing conditions, irrespective of whether these are external or internal to the enterprise. It is, however, necessary that the enterprise management utilizes early warning information which allows a fast, purposeful adaptation to changed conditions at an early stage [see also Krystek/Müller-Stevens (1999)].

Early warning information is often provided by (strategic) controlling. The management of the young enterprise may then still have enough time to react and hence more scope for their actions. From a wider point of view, not only risks but also opportunities for a new enterprise are transmitted through information systems. These are often seen as "early recognition systems" to support corporate foresight in the literature. In addition, early recognition systems also comprise recommendations for action, which can be utilized for planning purposes and decision making [Hahn/Hungenberg (2001); Krystek/Moldenhauer (2004)]. Against this background, enterprise founders should understand and use the business plan as a controlling and early recognition tool. With eyes on the future, it is sensible to convert the essential contents of a business plan into a continuous screening and evaluation of the business and its environment. The information generated from these activities may then be used for making entrepreneurial and strategic decision on the future direction of the enterprise.

## 3.2 Constitutional Aspects

Certain decisions during the emergence and founding stage may have a lasting "inertial" effect on an enterprise's corporate life in the future. Such decisions are *constitutive and fundamental long-term choices* [Scarborough/Zimmerer (1996)]; two of the most important ones are finding an appropriate **legal form** and **location** for the enterprise.

## 3.2.1 Choice of Company Form within a European Context

At first sight, the *formation of a legal entity* merely seems to be a formal, administrative act with marginal significance for the establishment of the entrepreneur's business in the market place. However, empirical studies indicate that legal institutions and company forms to choose from have a substantial impact on the structures and establishment strategies of new firms, e.g., start-up firms in the German biotechnology industry [Casper (2000)].

Correspondingly, the individual entrepreneur's task will be to choose a legal form which fits in with the venture's growth aspirations and the operational and strategic requirements. In particular, those founders planning to develop a multi-national European footprint may choose from a universe of European company forms and organizational structures. Looking across borders for an adequate legal form may pay off even for smaller ventures since the competition of company forms on offer in the Member States of the European Union has brought about a rich menu of forms; for the example case of **private limited companies** (i.e., where the liability of shareholders is limited to their equity endowments) there are the British *Ltd* (Limited), the French *SARL* (Société à responsabilité limitée), the Spanish *SLNE* (Sociedad Limitada Nueva Empresa), the Dutch *BV* (Besloten Vennootschap met Beperkte Aanspraklijkheid) and the German *GmbH* (Gesellschaft mit beschränkter Haftung) to name but a few. Overall, this menu features differences in legal founding costs, capital requirements, formal structures etc. As a constitutive entrepreneurial choice, opting for a specific legal entity is an irreversible commitment to the venture [Delmar/Shane (2004a)] and a constitutive decision with huge long-term impacts, e.g., on the public or private financing of the firm.

### 3.2.1.1 Significance of Legal-entity Formation in the Start-up Process

There are numerous other start-up activities which entrepreneurs do engage in during the pre-founding and start-up process, for example, renting office space, hiring personnel, talking to banks and writing a business plan. [Gartner et al. (2004) offer an excellent overview of typical start-up activities based on data from the US Panel Study of Entrepreneurial Dynamics.] While the development process of new ventures is typically quite fuzzy with numerous twists and turns along the way [Aldrich (1999)], the formation of a legal entity for the business sticks out as it marks the formal point of birth of the business organization. Essentially, the constitution of the venture as a legal entity is the point in time when the business becomes visible and institutionally identifiable for external parties and stakeholders within the market place. Constituting the venture legally in a proper way (including required registrations, e.g., with tax authorities, and permissions to do business) is important. This is because new enterprises lack a reputation and identifiable track-record in the eyes of external resource providers to new ventures (such as potential investors and employees deciding to work for the start-up or work elsewhere). [See the concept of *liabilities of newness* of start-up firms introduced in chapter 1.1.5 above; also see Gruber/ Henkel (2004) for an interesting practical discussion of such liabilities within the *open source software industry*.]

The acceptance of external resource holders like investors and suppliers is of concern to founders because their primary task will be to construct a resource base, which will be difficult for a new organization starting almost from scratch [Brush (2001)]. To put it another way, founding a new business frequently requires attracting resources from external resource owners, who need to be convinced of the venture's economic sustainability and the trustworthiness of its founders. Of course, there are many factors other than committing the venture to a legally binding form of business conduct which contribute to a convincing start-up concept (e.g., writing a proper business plan – see chapter 3.1). However, the role of building a legal entity and formal structure for the venture will be to make a choice of legal form which – among other factors – facilitates smooth access to resources like human and financial resources as well as vital information and network contacts [Grundei/Talaulicar (2002)]. A study on Swedish emerging new ventures by Delmar and Shane (2004) has shown that *founding a legal entity for a venture project early on in the process generally enhances survival chances*, supposedly because this is a first step to address concerns of vital external resource providers about the acceptability of the venture in the market place. Essentially this may be since building a visible institutional entity allows to display conformance with governmental rules and business regulations in a situation where the entrepreneur has only limited options to prove that the venture will be a proper, sustainable business firm in the future [Shane (2003)]. In the case of *internet start-ups*, Aldrich and Baker (2001) show this struggle to gain acceptance and establish as a business where faith in a new seller of goods via the internet (e.g., in terms of the accountability of the company regarding deliveries and warranties) is essential for customer acceptance.

To put it in a nutshell, entrepreneurs will have to appreciate the need for (and benefits of) documenting conformity to business regulations by opting for a certain legal structure of their business. But, when choosing a legal structure, founders need to make "efficiency considerations" allowing for speedy decision-making and operational flexibility which is essential for new ventures, in particular those operating in new, innovative sectors like nanotechnology. For a venture trying to develop and market a new product in this sector a legal form is required which, amongst other requirements, allows:

- taking on board both large strategic investors (e.g., as technology and marketing partners) as well as financial venture capital investors,
- making changes to its shareholder structure over time,
- seeking additional investment (e.g., in case of problems to establish a series production),
- making fast management decisions on new marketing measures (perhaps to speed up market entry in the face of unforeseeable competition).

### 3.2.1.2 Choosing a Principal Type of Business Ownership

While there are rules for commercial businesses to conform to (i.e., "the restrictiveness of regulations is not simply given to an entrepreneur but depends on the founder's choice of a specific legal form" [Grundei/Talaulicar (2002), p. 2]; at the same time, there will be *no single perfect legal form* to follow. Essentially, entrepreneurs will have to balance potential benefits of internal efficiency and external conformance in trying to find an approach that works [Bhide (2000)]. For example, it is said that small non-incorporated firms (e.g., partnerships) allow faster, more independent decision-making as compared with incorporated enterprises, which have a potentially easier access to resources going in their favour.

Generally, the different types of enterprises offer different characteristics and features, serving the needs of founders with a diverse range of business projects. However, it is important to note that most businesses are small **non-incorporated enterprises** [cf. Aldrich (1999), Storey (1994) and Daumke/Kessler (2000) for the US, UK, and German case respectively]. And it is commonly assumed that, amongst **incorporated enterprise** formats, the public (stock) company is the typical form for large-scale enterprises and established firms. However, the latter is also often opted for by founders of high-tech start-ups with ambitious growth aspirations and substantial needs for debt capital in the seven or even eight digits (e.g., in the life science, software, or green-technology sector). The specific needs for start-up capital and other typical **decision criteria for choosing a legal form** for one's business are depicted in Table 3-5 below and will be put in the basic context of the two principal types of enterprises, i.e., *non-incorporated business partnerships* and *incorporated companies*. The last two sections 3.2.1.3 and 3.2.1.4 will then address the European context (including the Pan-European format of the "European Public Company" – Societas Europaea). See Table 3-5.

***Table 3-5:*** *Choosing a company form: typical decision criteria for founders*

| Choice of legal form: potential decision criteria |
|---|
| – required start-up capital (up to break even) |
| – growth objectives |
| – planned international coverage (if any) |
| – founders' initial capital endowments |
| – minimum capital requirement of company form |
| – specific start-up and running costs |
| – reputation of company form |
| – founding shareholders and management |
| – liability considerations |
| – taxation |

Most new enterprises in their early stages of development need **finance** from outside the business since generated cash flows are insufficient for the business to be self-sustainable in the beginning. However, the *required amount of start-up capital* to fund the business and its *planned growth* until break-even is reached may vary significantly. For many new enterprises staying small, self-financing by the founders will be sufficient. Those founders may not need a legal form which facilitates substantial external fund-raising from the public. However, fast growing high-technology ventures may want to build a legal platform for raising large amounts of external equity and debt capital. This may be easier with an incorporated company; hence this route may well be preferable for those types of ventures.

Note also that for high-technology ventures attracting talented, yet scarce, human resources (e.g., software engineers, biochemists etc.) may be difficult in face of established and well-known large firms competing for talent. Here, incorporated formats, in particular stock corporations, allow founders to offer potential employees the possibility to participate in the future prospects of the enterprise (e.g., via employee stock-option schemes). Moreover, innovative firm founders with little management experience frequently have considerable requirements for information and management counselling. Here, external shareholders, industry professionals and consultants on the supervisory and **management board** of incorporated firms (e.g., as non-executive directors) offer vital access to specific knowledge and networking contacts within the venture's industry. [For analysis on these aspects see Fiegener et al. (2000) as well as for the possible liaising and supporting role of board members in the context of small firms.]

There are at least two central aspects that make investments in incorporated start-up firms in particular manageable and attractive for external financiers: First, the *liability* of investors may usually be limited to their equity stake in the business (rather than being liable with their personal assets as is the case with some of the non-incorporated forms of private businesses). This **limitation of liability** is regularly considered attractive by the founders themselves as well. However, in practice, restricting one's liability to the legally required minimum of equity capital will seldom be realizable for founders as bank lenders will demand collateral or personal guarantees. Moreover, external venture capital investors frequently expect substantial financial commitments to be made by the founders themselves in order to forestall agency problems. Second, from the perspective of external investors and lenders to a new enterprise, incorporated legal formats commonly offer sophisticated corporate governance mechanisms to protect their interests and defend against opportunistic behaviour by the founders managing the business. [See Chapter 6.3.4.3 (Investment Phase) for the relevance of such agency problems. However note also that managerial agency issues may be less concerning in start-up contexts since founders, in contrast to managers, usually own equity stakes in their businesses; Alvarez (2005).]

In particular, there are not only **minimum-capitalization requirements** which may vary substantially across different legal forms and tend to be higher for incorporated forms (see, however, also the discussion in 3.2.1.2 below), but there also are substantial **administrative and financial accounting requirements** demanded by law in view of transparent rights to information of external financiers and other stakeholders of the start-up firm. Overall, the fact that legal requirements for incorporated businesses may be more demanding and the higher visibility of incorporated businesses (not least because large, established businesses tend to be public corporations) may abet the **reputation** of such formats.

However, while these requirements may facilitate the (large-scale) acquisition of capital and other resources by documenting reliability, there are also potential drawbacks to be considered by founders. Founding an incorporated company (rather than a partnership) will usually incur higher **start-up and running** costs. Note too that these costs essentially also include opportunity costs in terms of allocating scarce management time to requirements such as getting listed in the register of companies and preparing detailed annual financial statements. The latter may have a noticeable impact on the start-up's administrative running costs since meeting financial reporting requirements for private limited and, in particular, public limited corporations may need frequent external assistance by tax advisers and accountants. Finally, the governance mechanisms allowing external financiers to control and monitor the founders' management of the enterprise may be detrimental for the **speed of decision-making** in incorporated businesses as compared to the relatively independent and prompt decision-making by the entrepreneurs themselves in non-incorporated ones. In particular, the potential slowness of collective decision-making in incorporated businesses may be critical for innovative, technology-driven start-ups operating in a high velocity environment [cf. Venkatraman (2000) for the case of building adequate governance structures in "dot.com" start-ups]. In practice, for such ventures there may be some leeway in designing a tailor-made individual **governance structure**, e.g., by opting for a system with a strong founder CEO (chief executive officer) taking the lead in ensuring timely decision-making. However, the potential scope for an active management and "fine tuning" of governance structures will depend on the corporation law of the enterprise's home country [for example, it may be more difficult to implement an effective CEO-system in jurisdictions following a strong two-tier board tradition such as in countries in Continental Europe].

In summation, there will be advantages and disadvantages to be weighed by founders (e.g., using a scoring model; see chapter 3.2.2) with regard to both incorporated and non-incorporated formats alongside the main aspects of management discretion in decision-making, resource access and specific founding as well as running costs. The latter will also be an important issue when considering the European dimension of choosing a legal form for a new enterprise.

#### 3.2.1.3 Competition of Private Limited Company Forms in Europe

At the European level, the possibility for discretionary entrepreneurial decision-making stems from the freedom to choose a company form within the corporate governance framework of EU company law. In particular, the European Court of Justice (ECJ) has clarified "that the right of establishment allows foreign investors to incorporate a business under a more attractive foreign company statute and operate that business in another Member State in the form of a branch" [Mäntysaari (2005), p. 54; also cf. Westermann, (2005), p. 11]. [This view has been articulated in the court's rulings on the *real seat doctrine*, a perspective held by a number of Continental-European countries, arguing that the applicable law ought to be the national law at the location of the company's principal operational place of business – see in particular the ECJ rulings on the cases of Centros, Überseering and Inspire Act between 1999 and 2003.]

Company founders do have a meaningful choice with regard to corporate governance and legal structure because company forms and governance systems differ across EU Member States. [The most prominent example is the traditional difference between the Anglo-Saxon one-tier board system and the Continental two-tier system with its traditional separation of company management and supervisory monitoring; cf. Plessis et al. (2007) and the edited volumes by Clarke (2005) and Schröter (2008) with contributions from different European countries.] From the common-market perspective of the European Union there have been attempts to *harmonize company law and governance structures* in Europe in order to avoid a "*race to the bottom*" of competing jurisdictions between the Member States. In particular, "corporate law shopping and fears of the popularity of incorporating as a UK [private] limited liability company have already resulted in the amendment of the company laws of some Member States" [Mäntysaari (2005), p. 39; see below for examples.]

Despite the presence of the European Union, there is still considerable diversity in the characteristics of national **forms of private limited companies** across Europe [Mellert/Verführth (2005)]. This is particularly true in comparison to European harmonization efforts (and de facto similarities) regarding stock corporations as public limited companies (foremost the Pan-European Societas Europaea, but also the notable similarities between national forms like the British public limited company *Plc*, the German Aktiengesellschaft *AG*, the French Société Anonyme *SA* and the Dutch Naamloze Vennootschap *NV*). In the following we concentrate on entrepreneurs' choices from European forms of private limited liability companies, in particular critically discussing the possibility to operate as a UK Limited (i.e., private company limited by shares *Ltd*) from a Continental-European perspective. This is not only due to the marked enough differences between the national forms of private limited companies but also because of the "numerical popularity" of this type of corporation amongst small business founders [e.g., in France, Mellert/Verfürth (2005), p. 121 and Germany, Mäntysaari (2005), p. 242].

Existing competition of company forms to choose from has led Continental-European countries to amend their company law, in particular with regard to the popular form of *private* limited liability enterprises. For example, Spain has introduced the new Sociedad Limitada Nueva Empresa – *SLNE* which may be founded faster than previous forms. France has simplified her existing law regarding the Société à responsabilité limitée – *SARL*, in particular abolishing former minimum capitalization requirements for *SARLs*. The latest effort has been a decision of the German parliament to modernize existing regulation (GmbH-Gesetz) effective from November 2008. The intention of the legislator was to speed up and simplify the founding of private limited liability companies in Germany. In particular, the new law is designed to allow a low-cost, standardized founding procedure as well as a new Unternehmergesellschaft (a one-man limited company similar to the French Entreprise Unipersonnelle à Responsabilité Limitée *EURL*). This new form available to business founders will have no minimum capitalization requirements while the traditional German *GmbH* still requires a share capital of 25,000 Euro. This modernization took place against the background of an increasing popularity of the UK Limited liability company among small business founders; typical reasons for this popularity are argued to be the high flexibility of this form and the low "costs" of benefiting from a limited liability status in terms of minimum capital requirements, founding expenses etc. [e.g., Mäntysaari (2005), p. 243]. However, in addition to these potential advantages, other characteristics of the UK Ltd should be considered as well from the perspective of a foreign business founder.

While administrative founding costs of a UK Ltd are often perceived to be fairly low (partly because there is no need for an attesting notary and no minimum capital), it is worth noting that the funds from minimum capital requirements existing in other countries are still available to the business which might need at least some start-up capital anyway [cf. for this and the following Mellert/Verfürth (2005)]. However, in contrast to non-recurring founding costs, entrepreneurs should also consider the time and effort required to run a UK Ltd in the future. These expenses (partly related to the fact that the business is to be incorporated within a foreign jurisdiction) may well be considerable foiling initially attractive founding expenses for a UK Ltd. In particular, there may be additional costs relating to registration with the registrar of companies for England and Wales and providing mandatory annual reports to the Companies House. These recurring costs can include expenses and fees for translators, attorneys and consultants who may be needed so as to assist founders with meeting the accounting and other reporting commitments required by UK company law. Namely, these are (de facto) requirements to provide frequent audited financial accounts according to UK accounting standards as well as an annual return. Internally, there are costs for the company secretary position responsible for obligatory record-keeping in preparation of the external reports. Finally, founders should also be aware of the fact that disclosure penalties for exceeding statutory periods for submitting those reports may be more severe than elsewhere. When operating branches of an incorporated UK Ltd in other European countries, founders should also check whether it is required for this branch to register with the local authorities in these countries as well and whether additional financial reports will be needed. [Also note that a voluntary registration of the business may also be useful to combat potential acceptance problems of the UK Ltd with external stakeholders; Mellert and Verfürth (2005) report on image problems because of the "quick and easy" founding approach of "UK Limiteds" and their supposed involvement in unsound business practices.]

There are, of course, also a number of Continental-European alternatives to the UK Ltd, all of which may feature different advantages and disadvantages from the founder's perspective. For example, there are the above-mentioned French SARL, the German GmbH, the Spanish SLNE or the Dutch BV and Italian SRL (Società a responsabilità limitata) amongst many others. [In fact, most EU Member States have their own form of private limited companies, for the new Eastern-European EU members e.g., the Polish Spólka z organiczona odpowiedzialnoscia "Sp. z.o.o." or the Czech Spolecnost s rucením omezeným "Sp. s r.o."]

There are many differences across European countries with regard to requirements for minimum capital, public registration, *audited* external accounting (mainly in the United Kingdom and Ireland) etc., which seem to offer founders an attractive and uncomplicated choice. However, there are also detailed country-specific regulations in the establishment and running of a private limited company which are based on traditional differences in judicial conceptions of company law. For example, in the Dutch case:

- In the Netherlands the executive directors (bestuurders) of a BV are not bound to instructions and directives of the general meeting (algemeene vergadering van aandeelhouders), making the BV less attractive from a shareholders' perspective [e.g., in comparison to the German GmbH where such binding directives are possible; Mellert/Verfürth (2005), p. 152].

- The waiting time and expenses for the company to be registered may vary significantly, e.g., depending on policies for notary company registration and examinations required by law (in this case the obligatory inspection of the company's founders by the Dutch Ministry of Justice). While the result of this examination is pending (verklaring van geen bezwaar), the company may be registered and is allowed to act as a "BV i. o." (in oprichting – in the course of formation). However, founders should be aware that in this inter-mediate period the firm will be considered as a non-incorporated partnership with the consequence that persons acting on behalf of the company will be liable with their personal assets.

- In order to raise the capital investments required by the founders, services provided by founding shareholders are not allowed to be utilized as contributions in-kind. This is similar to the German situation but different in the United Kingdom and France where investments in kind (apports en nature) and, since 2001, also contributions in services (apports en industrie) are allowed.

While the mentioned particularities of Dutch company law are by no means complete, they show that founding a new business in a legal form other than those known in the home country of the founder may require consideration of numerous *country-specific aspects*. The complexity involved in opting for a foreign company form may well cause substantial transaction costs (e.g., search, consulting, contracting, monitoring costs) which discount the attractiveness of "going abroad" when choosing a legal form for a new enterprise. In summation, founders may consider the final verdict of Mellert/Verführth (2005) to be reasonable, i.e., that foreign corporation forms will often be unsuitable for founders of small firms with no substantial growth motivation for their business. This is essentially because additional costs for legal and tax advisors, registration fees, administrative expenses and additional accounting requirements may be substantial in relation to the (small) size of planned business operations.

In contrast, for ambitious entrepreneurs planning a somewhat larger business operation it may well pay off to consider foreign company forms. However, it will be impossible to compare the legal details of all company forms in the many different European countries alongside the above list of decision criteria (cf. Table 3-5). Instead, entrepreneurs should follow a number of central questions when trying to decide whether a foreign company form (and what kind of form) may be suitable for their purposes. [Further online information on possible company forms on offer in different countries may be found on the websites of official authorities and other institutions – for example, www.companieshouse.gov.uk (United Kingdom); www.euridile.inpi.fr (France); www.infocamere.it (Italy); www.kvk.nl (The Netherlands); www.rmc.es (Spain).] Questions that need asking in this context are:

- Will my business have international customers and other stakeholders?
- Do I speak the language of the country which offers a possible legal form for my business?
- Will I need legal and other advice both for founding *and* running the company?
- What are the requirements for registration of the company?
- What kind of annual financial reporting will be necessary?
- What are the legal consequences of contraventions, e.g., in terms of disclosure obligations?
- Will investors and bankers accept the considered legal form?
- What will the "de facto liability" of founders be in the course of the establishment process and when running the business in the future?
- In the case of planned business operations in the entrepreneur's home country or countries other than the national jurisdiction of incorporation of the considered legal form: Will it be necessary to found separate subsidiaries or branches and what will be the additional costs of this?

#### 3.2.1.4 Societas Europaea (SE) a legal Form for High-growth Companies

Entrepreneurs' access to resources during the establishment process of their businesses appears to have an important effect on the internationalization and export involvement of firms. [See, for example, the study by Moen/Servais (2002) on the export behaviour of SMEs from Scandinavia and France.] It has been highlighted above that the choice of an adequate legal form may also facilitate the access to resources, in particular capital. For new enterprises striving for rapid growth and an early internationalization of their operations not only foreign company types but also a *supranational form of corporation* may be considered; this does not necessarily have to be right at the formation of the enterprise but rather in the course of its growth and development process after founding. For the European case in particular such a supranational legal form is the **SE as a European public limited company**. [The future relevance (and acceptance) in the business community of the Société fermée européenne as a Pan-European form of private limited corporation seems rather uncertain.]

The SE is available in the European Union (respectively the European Economic Area) since the end of 2004. [The edited volume by Oplustil/Teichmann (2004) provides an overview on the rationale of the introduction process of the SE in different European countries at that time; also cf. Vutt/Vutt (2007).] The first one was *MPIT Structured Financial Services SE* which operates in the Benelux countries and was founded as a subsidiary SE, the possibly most prominent one is *Allianz SE*, Germany's largest insurance and financial services company. The formal basis of the SE is the **European Company Statute**. However, the statute only addresses a number of core aspects (start-up options; internal corporate structure, closure); other issues are left to the national law of EU Member States on public limited liability corporations [Enriques (2004)]. The Pan-European character of the SE stems from the fact that the statute demands founding institutions to originate from at least two EU Member states. The SE is therefore an unsuitable corporate vehicle for small home-grown enterprises which are founded to operate in a purely domestic context.

Accordingly, the SE has been attractive to established multi-national companies. Notably, however, also *Mensch und Maschine SE*, a fast growing software firm which went public at the time of the new economy boom (then listed at the German New Market stock exchange segment), has changed its corporate form from a German AG (Aktiengesellschaft) to become a European SE in 2005. On its website, the company reports that this form fits well with the European expansion of an originally German high-tech start-up firm (www.mum.de). Generally speaking, the SE may become an interesting company form in the course of the expansion and internationalization process of fast-growing new enterprises, facilitating their establishment in the European market place. In such a process, there are different *paths towards founding an SE* [Binder et al. (2007)]:

- founding a *holding* SE by (at least) two companies incorporated in different EU Member States,

- establishing a *subsidiary* SE,
- converting a (European) stock corporation which has operated a subsidiary in another EU Member state for at least two years into a *conversion* SE,
- forming a *merger* SE by consolidating stock corporations from at least two different EU Member States.

Irrespective of the specific formation path chosen, the minimum capital requirement will be 120,000 Euro (or, if the national law of the Member State where the SE is to be incorporated demands a higher level of minimum capitalization, the threshold amount required in that country). This means that because of the European Company Statute's frequent references to national company law, the SE is not an appropriate form for start-up firms simply seeking to bypass national minimum capitalization requirements [Mellert/Verfürth (2005), p. 289]. However, for those willing to accept such hurdles, the SE Statute offers flexibility to utilize the differences in governance forms and national company laws of the Member States [i.e., engage in corporate law shopping; Enriques (2004)]. In particular, the decision for an internal one-tier or two-tier board structure is another aspect where the statute refers to the national legal practice in the Member States, i.e., explicitly allowing both governance forms.

The possibility to opt for a one-tier board structure is put forward as a major advantage of the SE for Continental European enterprises. [For this and other advantages as well as disadvantages see Binder et al. (2007), p. 32.] This is since it alleviates taking on board foreign, particularly Anglo-Saxon investors, who are traditionally more familiar with the one-tier system. Typical further **advantages** are:

- savings in transaction costs in the operation of subsidiaries and branches in different EU Member States and
- simplification of cross-border mergers and collaborative joint-ventures [Enriques (2004)].

However, on the *debit side* there are typically higher costs and amounts of required time and effort for the formation of the SE in the first place (as compared to founding a stock corporation in just one Member State where only the national company law of this state will be relevant). Finally, the legal regime around SEs is rather opaque because of the SE Statute's focus on core aspects with references to the different national laws; namely, there will be relevant rules in the Statute itself as well as in national bye-laws enacted to implement the Statute in the Member States and national laws on public limited companies in the different countries.

In summation, from the *entrepreneur's perspective* the additional costs involved in establishing a supranational company form as well as in using a foreign corporate vehicle (such as the UK Ltd), make such approaches unattractive to small new enterprises with little ambition to expand in size and reach. However, for those founders with planned large-scale international operations the menu of company forms outside their home country (including the European SE company itself) provides flexibility and alternative opportunities with room for corporate law shopping for the best form on offer across Europe. From the *perspective of European economic policy-making* such rivalry between various national corporate vehicles and governance systems is suitable for discovering and creating novel legal forms in an evolutionary process of institutional competition between different (national) jurisdictions [See Kerber (1997); also cf. Enriques (2004) for a similar idea in the specific context of European company law].

In particular, new forms are being created in the new East-European Member States, for in these transition economies the role of institutional regulation in the context of corporate governance will be to provide accepted and trusted company forms in order to reduce transaction costs for companies and their various stakeholders. [See Marinov/Heiman (1998) for a good example of the main considerations from an East-European perspective.] What needs to be avoided though is a counterproductive race to the bottom, by, for example, setting certain low minimum corporate governance standards at the European level. The role of founders in this process will be to make use of the variety of existing company forms, choosing a structure adequate for their individual business to be innovative and competitive in the global market place.

### 3.2.2 Choice of Location

"A significant part of the organizing process is finding an appropriate site for doing business" [Allen (2003), p. 283]. Often founders seem to make location decisions which are mainly based on their social networks and close personal ties, favouring locations close to where they live. [See, for example, Dahl/Sorensen (2007) for a study of location choices made by entrepreneurs from Denmark; also see Figueiredo et al. (2002) and Schmude (2003) for the cases of Portugal and Germany.] This potential "home bias" and focus on social criteria in location choices is understandable (and sensible in start-up projects where close network ties are paramount). However, the **choice of location** is a *constitutive decision problem*, as a decision once made for a definite location cannot normally be simply corrected, as it is often associated with specific, long-term fixed costs, such as, for instance, long-term rental agreements. The location choice is a decisive factor in the creation of an enterprise, and it is also important when establishing subsidiaries, branches, additional business premises or factories. Therefore, for the purpose of selecting a location, a specific location analysis should be carried out. In the location analysis, the potential location and possible alternatives are checked and compared, taking into account both the requirements of the enterprise and the location conditions.

The choice of location does not have the same significance for all enterprises and industries. For many enterprises, as, for instance, industrial enterprises, location decisions often go hand in hand with high investments, which cannot be quickly cancelled. This may not be the same for small service of retail start-ups where marketing aspects (rather than production) may be in the centre of location decisions. Whether a location is suitable for a young enterprise depends on many factors of the location in question, which can be classified into input-, output- and environment-oriented location factors [for an alternative list of possible criteria for making location choices see Allen (2003)]. **Input-oriented location factors** are, for instance, *real estate, building lots, worked material and raw material supply, availability and qualification of labour supply, access to public transportation, energy supply, environmental charges, public supplies and waste disposal etc.* **Output-oriented location factors** are, for instance, *sales markets* and the *competition.* **Environment-oriented location factors** are, for instance, *taxes, fees* and *regulations of authorities*. When classifying individual location factors according to their relevance, they may be assigned to the three groups of very important factors, important factors and less important factors. The group of **very important location factors** could, for instance, include the *qualification of the employees* or the tax burden. **Important location factors** could be the *infrastructure of the location, regulations of the authorities* or *energy costs.* Conceivable **less important location factors** could be, for instance, *nearness to the supplier* or *worked and raw material supply.* Within the framework of the location analysis, **"hard" location factors** (directly quantifiable and measurable factors) such as *rents, access to public transportation, transport costs, availability and qualification of labour supply,* could be analysed as an additional potential classification system. On the other hand, **"soft" location factors** (not always directly quantifiable and measurable factors) are also significant in the analysis, such as the *image of the location* or the *leisure value* for founders and employees. Which type of classification system is used in the location analysis is ultimately not decisive. It is, however, important that the founders identify and evaluate the relevant location factors for their individual start-up business [Bloech (1990); Domschke (1996); Domschke/Drexl (1996); Allen (2003); see also the articles by Kinkel (2004) and Dahl/Sorensen (2007)].

As numerous different factors have to be taken into account when choosing a suitable location, the decision should be based on multiple criteria. These cannot all be considered within the framework of an individual analytical process. For this reason, a compression of the factors and thereby a reduction of their complexity to a more manageable and workable dimension must be carried out, taking into account time, finance and personnel resources. It is the aim of the location analysis and choice to produce a match between the given **characteristic features of a location** and the **requirements of the enterprise.**

A **location analysis** can be carried out according to the following exemplary schedule:

- Preparation of a catalogue of relevant location factors
- Description and finer definition of the location factors (target values)
- Preparation of a requirement profile
- Pre-selection of possible locations on the basis of Knock-Out (K-O) criteria
- Evaluation of the individual locations using an evaluation system such as cost-benefit-analysis

When carrying out a location analysis, first, founders need to prepare a catalogue of the relevant location factors. The defined location factors must be described in detail, and criteria for measuring or evaluating them must be laid down. From a multitude of conceivable locations, a pre-selection should first be made to reduce the range of possible locations to a manageable number. For this possible "knock-out criteria" (K-O criteria) may be employed, which must be met by a location as a minimum to be considered at all. In this step, many unsuitable locations are already filtered out. For instance, access to public transportation, i.e., the necessity of a favourable connection to a motorway, can be formulated as a K-O criterion. At this point, it must be defined how a favourable connection is to be understood. It can, for instance, refer to the number of kilometres or to the time needed to reach the motorway. If these criteria are not met by a potential location, this location is eliminated.

The evaluation of the individual location factors may be based on a cost-benefit analysis. In practice, this is a common procedure for the evaluation of several location alternatives. In general, the cost-value analysis can be applied if the founders have multidimensional goals, and not all consequences of the decision can be evaluated from a monetary or financial point of view. In a cost-benefit analysis, all relevant location factors or target criteria are entered into a matrix.

Table 3-6 illustrates the possible structure of a cost-benefit analysis to make a location choice. This analysis contains the weighting (W) of the individual location factors as well as the evaluation (E) using a point scale from 1 to 10. Then a weighting (W) of the individual factors follows based on the importance which they have for the enterprise. An evaluation of the location factors can then be carried out for each location. The evaluation (E) is carried out by allocating point scores, perhaps on a scale from 1 to 10, with the multiplication of the evaluation with the relevant weighting factor giving a specific cost-benefit value per location factor. By summing up the individual cost-benefits, the total cost-benefit of the individual location is obtained. Although it is not possible to exclude any subjective factors of influence within the analysis, this evaluation procedure can nonetheless be a useful tool for founders for discussing and making location decisions.

*Table 3-6: Cost-benefit analysis for making location choices*

| | | Location A | | Location B | | Location C | |
|---|---|---|---|---|---|---|---|
| Location factor | *W* | *E* | *W*E* | *E* | *W*E* | *E* | *W*E* |
| Nearness to airport | 10% | 5 | 50 | 8 | 80 | 8 | 80 |
| Nearness to supplier | 15 % | 5 | 75 | 6 | 90 | 7 | 105 |
| Nearness to sales market | 15 % | 8 | 120 | 8 | 120 | 5 | 75 |
| Qualified employees | 20 % | 4 | 80 | 8 | 160 | 8 | 160 |
| Wages cost | 25 % | 4 | 100 | 6 | 150 | 5 | 125 |
| Life/leisure quality | 15 % | 4 | 60 | 4 | 60 | 8 | 120 |
| Total value | 100 % | | *485* | | *660* | | *665* |
| Rank | | | **3** | | **2** | | **1** |

After completion of the cost-benefit analysis, it may be advisable to carry out a sensitivity analysis for verifying the decision. This means that the weightings are varied. After that, a re-assessment with the same point values is applied, and individual cost-benefit values and total values are again calculated. In this way, it will be checked how the results of the initial analysis react to the change of the margin conditions of weighting [see also for main principles of cost-benefit analysis Zangemeister (1976); Hoffmeister (2000)].

# 3.3 Comprehension Test and Recommended Literature

## Comprehension Test

- What is a business plan and who should write a business plan? (3.1.1)
- What are the potential target groups of business plans? (3.1.1)
- List the main building blocks and chapters of a business plan. (3.1.2)
- Discuss the core contents of the above building blocks of business plans. (3.1.2)
- What is an executive summary and why is it an important part of the business plan? (3.1.2.1)
- Characterize the following concepts: liquidity plan (cash budget); pro forma income statement or profit and loss account; pro forma balance sheet. (3.1.2.7)
- How are the above concepts related to each other and what are their differences? (3.1.2.7)
- Develop an example structure for a liquidity plan (cash budget). (3.1.2.7)
- Discuss possible mistakes regarding the development of business plans. (3.1.3)
- Why are the choices of a legal form for a start-up and deciding on its location so important for founders? (3.2.1)
- In how far can the establishment of a legal entity for a venture project help to gain acceptance with external stakeholders of the new enterprise? (3.2.1.1)
- Name potential decision criteria for identifying an adequate company form for a new enterprise. (3.2.1.2)
- Discuss possible advantages and disadvantages of choosing a foreign company form like the UK private limited company (Ltd) from the perspective of a Continental-European entrepreneur. (3.2.1.3)
- Explain the Societas Europaea (SE) as a company form and make suggestions regarding its appropriateness for specific types of new ventures (small businesses versus high-growth international start-up companies). (3.2.1.4)
- Name possible decision criteria and factors for making location choices for new enterprises. (3.2.2)
- How can a cost-benefit analysis be used for making location decisions? (3.2.2)

## Recommended Literature

### Business Plan

*Allen, K. R.* (2003): Launching new ventures – an entrepreneurial approach, 3rd edition, Boston 2003.

*DeThomas, A. R./Derammelaere, S. A.* (2008): Writing a convincing business plan, 3rd edition, Hauppauge 2008.

*Dollinger, M. J.* (2003): Entrepreneurship, strategies and resources, 3rd edition, Upper Saddle River 2003.

*Ford, B. R./Bornstein, J. M./Pruitt, P. T.* (2007): The Ernst & Young business plan guide, Hoboken 2007.

*Sahlman, W. A.* (2008): How to Write a Great Business Plan, Boston 2008.

*Stutely, R.* (2002): The Definitive Business Plan: the fast-track to intelligent business planning for executives and entrepreneurs, 2nd edition, London 2002.

### Choosing a legal form for a new enterprise

*Delmar, F./Shane, S.* (2004): Legitimating first: organizing activities and the survival of new ventures, in: Journal of Business Venturing, 19 (3), 2004, pp. 385–410.

*Grundei, J./Talaulikar, T.* (2002): Company law and corporate governance of start-ups in Germany: legal stipulations, managerial requirements, and modification strategies, in: Journal of Management and Governance, 6 (1), 2002, pp. 1–27.

*Maentysaari, P.* (2005): Comparative corporate governance: shareholders as a rule-maker, Berlin et al. 2005.

*Oplustil, K./Teichmann, C.* (2004): The European company – all over Europe: a state-by-state account of the introduction of the European company, Berlin 2004.

# 4 Marketing

## 4.1 The Importance of Marketing in Young Enterprises

Marketing is of crucial importance for the success or failure of an enterprise, as its success is ultimately decided in the market, competing for the target customers. The degree of market orientation of an enterprise may well impact its overall business performance, both in the context of young and small enterprises and in the process of launching new products [Keh et al. (2007); Atuahene-Gima et al. (2005)]. [See also the entrepreneurial element in market-driven behaviour as creative distruction in firms such as *Starbucks* or *Dell*; Schindehutte/Morris/Kocak (2008)] Moreover, addressing marketing issues when establishing a new enterprise is also considered essential by important stakeholders such as equity investors [as noted in Hills/Hultman/Miles (2008) referring to a study which has been developed already some time ago in Hills (1984)]. In practice, e.g., venture capitalists will look at how the enterprise plans to enter the market, which target groups will be addressed, and how the firm's product or service offer will be communicated and distributed to potential customers; this is since successful market establishment and growing sales volumes is a sine quo non for financial prosperity in the long run.

For the particular challenge of marketing products and services in the context of new or young enterprises, different views on the essence of **entrepreneurial marketing** have evolved in the marketing and entrepreneurship literature. On the one hand, entrepreneurial marketing "has been most frequently associated with marketing activities in firms that are small and resource constrained, and therefore must rely on creative and often unsophisticated marketing tactics" [Morris et al. (2002b), p. 4]. On the other hand, the concept has been connected to the sometimes less planned and more visionary marketing ideas of the entrepreneur [Morris et al. (2002b)]. While small and new enterprises indeed do not command the multi-million Euro marketing budgets that large enterprises have, still *entrepreneurial* marketing thinking does not use resource restrictions as a starting point. Rather, entrepreneurial marketing is opportunity-driven behaviour and as such can be defined as: "the proactive identification and exploitation of opportunities for acquiring and retaining profitable customers through innovative approaches to risk management, resource leveraging and value creation" [Morris et al. (2002b), p. 5]. However, still often entrepreneurs will have to consider non-standard marketing measures involving, e.g., guerrilla marketing tactics (see below); this is due to the marked enough differences of their venture as compared to



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large, multi-national enterprises. The following seven dimensions describe the core of what makes entrepreneurial marketing activities [Morris et al. (2002b)]:

- Pro-activeness
- Calculated risk-taking
- Innovativeness
- Opportunity focus
- Resource leveraging
- Customer intensity
- Value creation

Some of these dimensions may also be found in the marketing activities of large, established firms but occur in a different form in new enterprises; e.g., concerning customer intensity, the relationships with regular customers may be closer in new and small enterprises). The first five of the seven dimensions are, however, characteristic of new ventures. For example, the view of marketing manager in a multi-national enterprise may be more departmental budget-driven than the opportunity-driven vision of the entrepreneurs relating to the possible target customers of their new enterprises.

In general, marketing is defined in different ways by the relevant literature, with the common core of many definitions of the concept being that **marketing** is a way of enterprise management dedicated to customer needs and thereby market-oriented through *systematic and purposeful management measures* [Meffert (1997)]. Today, marketing also involves the customer-oriented management of socio-economic exchange ties between many different entities beyond industrial enterprises and their customers, e.g., marketing of public services or non-profit organizations [see the works of Kotler (1999), among others, on this expansion originating from a generic concept of marketing]. In short, marketing is an essential tool both for product and service-based start-up enterprises. In for-profit contexts, marketing involves the generation of customer preferences and sustainable competition advantages through positive entrepreneurial actions. Yet, technology-oriented start-ups in particular tend to neglect customer needs and marketing (sometimes because founder teams have a background which is focused exclusively on engineering and technology). However, investors set great store by a functioning, target-oriented marketing in young enterprises. A field interviewing of over 200 venture capital investors, carried out by the Wharton School in the USA, led to the result that the highest score of 6.7 from a maximum of 7 points was given to marketing among all business management functions. [Lodish at al. (2001)]. It is, however, true that marketing in its widest sense should not only be understood as only a management function, but also as a concept to be implemented in a holistic approach, which extends over the enterprise as a whole.

The **marketing of young enterprises** *is to be viewed primarily in relation to the degree of newness of the enterprise, its products and services, the low level of market presence, its small size, the often-turbulent environment, as well as the limited resources* [McGrath (1996); Coviello et al. (2000)]. The resources are used to meet the customer requirements so that the products are oriented towards the needs of the customer and create customer loyalty. In contrast to large established enterprises, such as, for instance, *Nokia* or *Microsoft*, young enterprises are considerably more restricted in their resources. Young enterprises face the challenge of still having to build up a market presence and a brand name and often they will have to use a different approach towards brand establishment as compared to established enterprises with their multi-million Euro marketing budgets [Morris et al. (2002b)]. The East-German champagne-producer *Rotkäppchen,* for instance, succeeded in establishing its brand in Germany after the reunification against the background of competitors with much deeper pockets. Measured by its turnover, this enterprise advanced to be the German market leader in the first years of the new millennium and has outstripped so far all well-known German brands in the champagne and sparkling wine sector. In the study "Best Brands" (2009), the first German market ranking based on a representative study, the brand *Rotkäppchen* occupied the ninth place in the category *"strongest product brand"* for the year 2009 amongst other well-known brands, such as, for instance, *Adidas, Canon, Coca-Cola, Microsoft, Lego,* and *Tchibo.* Especially if they intend to go beyond national borders and to establish an international or global brand name and market presence, young enterprises have to meet many challenges. In his book "Monkey Business", the entrepreneur Paul van de Velde describes his entrepreneurial experiences which can be seen as an example in this context. With a partner, he founded the company *Kipling* ("back to the bag") in Gent, Belgium, in 1987. It was an essential part of van de Velde´s marketing approach to establish an international brand rather than a trademark. Kipling has become Belgium´s most successful fashion label and a strong international brand.

Customers can be classified into different target groups which are reflected in the orientation of marketing approaches. In a function-based observation, the marketing can, for example, be differentiated as follows:

- Consumer goods marketing (business-to-consumer/B2C)
- Investment goods or industrial marketing (business-to-business/B2B)
- Services marketing
- Financial marketing
- Non-profit marketing
- Internal marketing

The marketing in the B2C-area of many large established enterprises, such as, for instance, *Procter & Gamble* or *Coca Cola,* is a very cost-intensive managerial task. The expensive marketing measures, which are developed and applied by the specialized marketing departments of large enterprises as well as by external marketing and advertising agencies, as shown by expensive television advertising spots and radio commercials or coloured whole-page ads in leading nation-wide daily newspapers or magazines is an example of this.

For young enterprises, which typically have a *low marketing budget* at their disposal, such cost-intensive marketing activities can rarely be financed. Small and young enterprises find it particularly difficult today to gain the attention of customers, who are saturated with advertising and a flood of information, and thus to make a successful entry into the market. However, it is always impressive how new enterprises manage to operate successfully in saturated markets through clever marketing strategies and measures. The Austrian enterprise *Red Bull*, for instance, which was founded in 1987 and started first with a budget of only 1 million Euro, was able to conquer successive market shares in the segment of caffeine containing soft drinks in Europe and other parts of the world, using unconventional marketing strategies. An enterprise such as *Red Bull* whose product – an energy drink tasting of gummy bear sweets – is in principle easy to imitate, can only be successful thanks to an unusual, original and creative marketing.

The challenge for almost all start-up enterprises with low market entry barriers lies in attracting the attention of the customers by applying innovative marketing methods and original, entertaining campaigns, as well as in the economic employment and the creative utilization of the available resources and entrepreneurial networks. The successful founder of the computer enterprise *Dell*, Michael Dell, was fired with enthusiasm at an early stage for the new communication and distribution channels. As a strong entrepreneurial personality, he attracted the attention of the customers through slogans such as "*It gives me pleasure to do things which others consider to be impossible*". On the other hand, it was above all the use of the then innovative distribution channel of the internet, through which he marketed his computers at a better price than his competitors, such as, for instance, *IBM,* and was thus able to gain a competitive advantage.

From the theoretical point of view, Jay Conrad Levinson, in particular, with his book **Guerrilla Marketing** made an authoritative contribution in the USA as early as the 1980s by showing small and young enterprises new, innovative and creative ways of communicating with potential target customers in a cost-saving way. In marketing literature, guerrilla-marketing is also often called *low budget marketing.* The fundamental objective of guerrilla marketing is to attract maximum attention in the customer target group even with a low budget through unconventional, original ideas and their application. In times when cost savings are of great importance for enterprises, many small and large enterprises use guerrilla marketing. Examples for the tools of guerrilla marketing are the purchase of remaining advertising seconds on television at supposedly unattractive late hours, use of readers' letters with hidden references to their own products or unusual promotion campaigns, which cannot be recognized as such. Guerrilla marketing is carried out in a surprising, efficient, rebellious or unconventional and spectacular manner to achieve as great attention as possible in the target group. At the same time, many concrete actions of guerrilla marketing are *unique* and *time-limited*, as they follow the targets described above. Often, conventional standards or rules are also infringed in order to shock and to provoke. The problem is, however, that sometimes the opposite to the intended effect is achieved, and the chosen form of guerrilla marketing proves to be counter-productive. The borders are fluid here. The same applies to the border between infringing moral norms and breaking the law. It could, for instance, occur that an aggressive and shocking guerrilla-marketing acts against the moral sentiment of a community. Irrespective of these borderline cases, guerrilla marketing needs to be *creative and unconventional,* as already mentioned, in order to gain a high degree of attention [Levinson (1995); Levinson (1998)].

As an example in this context, the strong-growth American coffee chain *Starbucks* can be mentioned, which, in 2005, hit the headlines with an original advertising campaign. In major US cities such as New York, Seattle, Chicago and San Francisco, cars were driving around with special magnetic cups on their roofs. The cups looked like *Starbuck* mugs. Any passers-by who noticed a travelling cup on a car roof and informed the company received a gift voucher. Such an unusual advertising campaign, which was carried out to draw the attention of customers to *Starbucks*, is probably not only cheaper than classical advertising measures but also more efficient.

According to Jay Conrad Levinson, the 13 most important marketing secrets are as follows:

"1. *You must have commitment to your marketing program.*

2. *Think of that program as an investment.*

3. *See to it that your program is consistent.*

4. *Make your prospects confident in your firm.*

5. *You must be patient in order to keep a commitment.*

6. *You must see that marketing is an assortment of weapons.*

7. *You must know that profits come subsequent to the sale.*

8. *You must aim to run your firm in a way that makes it convenient for your customers.*

9. *Put an element of amazement in your marketing.*

10. *Use measurement to judge the effectiveness of your weapons.*

11. *Establish a situation of involvement between you and your customers.*

12. *Learn to become dependent upon other businesses and they upon you.*

13. *You must be skilled with the armament of guerrillas, which means technology." [Levinson (1998), p. 26]*

Young enterprises are faced with a multitude of **challenges in marketing**. When introducing new products with the help of suitable marketing measures, it is on the one hand necessary to carry out reliable market analyses and market research to calculate prices, identify target customers, develop and implement marketing strategies, establish distribution logistics, and to introduce a system for marketing control. At this stage, the enterprise must already have specific competences and resources at its disposal to achieve a successful introduction of a new product, yet, the enterprise must use marketing in order to establish a brand name or increase the level of brand-awareness in the first place. Customer relations must not only be built up with the product, but the enterprise must segment its target customers into groups and achieve its own positioning in the market. Product and customer relationship orientation do not only refer to the sale of the product, however. Customer relations are already built up in advance of the sales, e.g., through a friendly and competent advisory and support service. In addition, the relationship also includes service and maintenance of the product after the purchase. As regards service-oriented and maintenance-intensive industrial goods, in particular, the customers can make high demands. At the same time, the relationship of the customer to the young enterprise is characterized by typical reservations. Young enterprises are normally not well-known, their products have not yet proved themselves in the market and may have shortcomings [Morris et al. (2002b); Gruber (2003)]. Statistically, the risk that the young enterprise could fail and become insolvent is significantly higher than in established enterprises which have been active in the market for a long time. This means that they may possibly meet their contractual obligations only inadequately or not at all. In addition, a young enterprise's "lack of reputation and track record creates a heightened perception of risk on the part of the potential resource provider" [Brush (2001), p. 71]. Against this background, building trust and winning the confidence of customers and other stakeholders is a central challenge for the young enterprise [Aldrich (2000)]. In the context of marketing, this objective can mainly be achieved by building up a positive image through high competence and capability in problem solving or a sustained and comprehensive after-sales service. In addition, it is important to generate competitive advantages which can be clearly recognized by the customers. The product can, for instance, be of essentially better value or of higher quality, or the marketing of the young enterprise can be significantly better than that of the competition.

In comparison with young enterprises, most established large enterprises have a more comprehensive spectrum of marketing strategies and measures at their disposal, mainly because they have higher marketing budgets available. In large enterprises, marketing strategies are often applied which are geared towards the distribution of large quantities of products. This orientation requires other strategies, tools and resources than the marketing in small and young enterprises, where rather an individual, personalized customer care can be used. The differences between large and small enterprises do, however, not permit general statements and evaluations of strategies and measures, as different objectives and resources demand different strategies. [For empirical differences in marketing strategies depending on firm size, see Coviello et al.

(2000).] Because of their frequently less formalized organization structure, young enterprises have a better opportunity of reacting faster and more flexibly to customer needs than larger, established enterprises. The disadvantage of a small size structure thus turn into an advantage. Customers can, as a rule, be more intensively looked after by young enterprises. Thus, a personal and close relationship between the enterprise and its customers can be built up, which may lead to a comparative competitive advantage for the young enterprise.

A favourable economic setting and effective original marketing may be essential factors for the successful market establishment of new enterprises, but it is important to note that the paths of individual ventures towards successful establishment will be fuzzy and heterogeneous [Aldrich (1999)]. Nonetheless, it is also essential to generate a sound and convincing marketing concept or marketing plan from which specific market targets, strategies and measures will evolve.

## 4.2 Marketing Planning and the Marketing Plan

The founder of the enterprise *Red Bull*, Dietrich Mateschitz, gave up his career as marketing director at the tooth paste manufacturer *Blendax* in the middle of the 1980s, to work on a marketing plan for the energy drink *Red Bull*. The personal trigger for the underlying business idea was a business trip to Japan in 1982, where he learned about the manufacturer of the energy drink *Lipovitan*, an enterprise which then had an important market position in Japan. On the basis of a sound marketing plan, Mateschitz, together with his Thai partner, acquired the licence for *Lipovitan* with the aim of introducing this soft drink into Europe. The marketing plan with its unconventional marketing measures for an original product *Red Bull*, as well as the clever market positioning, were central success factors of the enterprise right from the start. Even today, *Red Bull* is still successful through the creative employment of marketing measures, in particular through advertising, sports and event sponsoring as well as sampling, but also through public relations. Advertising spots are broadcast in cinema, television and radio, always accompanied by the slogan *Red Bull gives you wings*. Due to the small advertising budget at the beginning, *Red Bull* was active in sports sponsorship already at an early stage, mainly concentrating on then new-trend sports such as free-climbing, beach volley-ball and mountain biking. The company's event marketing toolbox comprises, for example, the *Red Bull Flying Days*, the *Red Bull Sun Festival* and the *Night of the Red Bull*. Moreover, the aim of the company's sampling measures is that by distributing drink samples in super markets and stores, potential customers acquire a taste for the cult drink *Red Bull*. In the past, the traditional media (e.g., daily newspapers) have often reported about *Red Bull*, both in a positive and negative ways, although the negative headlines have so far done no damage to the enterprise [see Schmeh (2004) for more details.

In young companies, marketing is often started spontaneously but is in many cases not thought through or planned deliberately. The successful example of *Red Bull*, however, illustrates that marketing planning is today an essential component of overall business and enterprise planning in new and young enterprises, especially those customer- and market-oriented enterprises. Too, marketing planning can form the basis for further partial plans within the business plan or in later corporate planning. For example, developing the turnover plan from the first years of business can be derived from estimated sales volumes and prices produced in the marketing plan.

In general, **marketing planning** can be defined as the *systematic, rational perception and analysis of the future development of the market and the enterprise with the objective of deriving aims, strategies and managerial guidelines for the development and implementation of marketing strategies.* From this point of view, the most important **phases of marketing planning** are *situation and environment analysis (including market forecasting), planning of marketing goals, strategy planning, development of integrated marketing policies (marketing mix), implementation* as well as continuous marketing controlling. Marketing planning crystallizes into a marketing plan.

The **marketing plan** contains in particular the *aims, strategies and tools of the enterprise with regard to marketing, e.g., to generate the attention of potential customers and to achieve sustained customer loyalty.* Marketing plans are, however, not a static construction but subject to continuous change throughout the development of new enterprises. Therefore, goals and marketing strategies must be adapted or redeveloped in the course of time to do due justice to the demands of changes in the environment and to enterprise growth. In the start-up phase, the marketing plan as a component of the business plan forms the basis for the marketing activities of the young enterprise. In the first phase, a strategy for introducing a product or service as well as a mix of marketing policies is developed and implemented. These policies need to be tailored to the limited size and resource base of the enterprise, in particular, the necessary resources which are used for securing the existence of the enterprise in the market place. In the context of the development of the marketing plan it can be important to concentrate more on the creation of a brand name, an increase in brand recognition, as well as on building-up a solid image for the enterprise, which can all assist in introducing new products.

Marketing plans must also generally take into account changed resource conditions, as extended resources also allow new tools, such as advertising in large coloured newspaper ads. An over-hasty adaptation of a marketing plan should, however, be avoided, as a sustained commitment to following a plan can be a crucial success factor for the enterprise. Marketing is an intensive process, which can show time-delayed effects, with both positive and negative results of marketing becoming evident after some time. In this context, the problem of the measurability of marketing activities arises. However, market-entry and expansion should also not be approached in a blind flight by entrepreneurs and marketing managers and therefore, a marketing controlling should be built up. Marketing controlling can generally assist in tracking the success of marketing policies in use, the enterprise's overall market success (e.g., in terms of sales figures) as well as in monitoring changes in the target group(s) of customers. As such marketing controlling can take on an advisory function when making strategic and operational decisions.

For the creation of the marketing plan of a young enterprise, the following steps can be recommended:

- Situation and environment analysis, including market forecasts
  - Analysis and prognosis of competition
  - Analysis and prognosis of target market
  - Market segmentation and positioning
  - Analysis of enterprise potential
  - Analysis of customer potential, needs and benefits
  - Analysis and prognosis of environmental developments
- Determination of marketing goals, strategies and budget
- Determination of marketing policy mix
  - Product or service policy
  - Price or contracting policy
  - Communication policy
  - Distribution policy
- Establishing marketing controlling

The marketing plan usually contains *analyses and forecasts of the current and future market development* and *of the competition and customers*, i.e., customer potential and their preferences. Moreover, the overall marketing goals and the marketing strategies, such as, for instance, market entry strategies, are to be planned. At the same time, the shortness of resources, perhaps in the form of a low marketing budget, is to be considered as a restriction. With regard to the effect of marketing strategies and measures, the establishment of a marketing controlling is required. In the end, a marketing plan can become quite complex in an individual case. The communication of this plan to employees (as well as to external parties) can thereby constitute a challenge for the enterprise. Even so, it is necessary within the context of a market-oriented enterprise management. In particular, drawing up a short, precise version of the marketing plan (for the purpose of communication within the enterprise that will comprise the core points of the complete plan) is recommended.

For effective marketing planning, the following questions may be relevant:

- What are the overall marketing objectives?
- What budget can be made available at what time?
- What is the target market of the enterprise?
- Who are the customers of the enterprise and how are customer relationships to be built?
- How does the product satisfy the needs of the customers?
- How do products of competitors meet the needs of the customers?
- How do the customers perceive the enterprise?
- What is the unique selling proposition of the enterprise's product(s) or services?
- What marketing instruments are to be used?
- How will the customers' attention be attracted?

### 4.2.1 Situation and Environment Analysis

The **situation analysis** refers to a *comprehensive analysis of the current conditions and situation of the enterprise itself as well as of the external* environment, forming a basis for sound marketing planning. Within the situation analysis, all relevant information is collected in the enterprise as well as in the micro and macro environment. The acquired information and data create the decision-basis for determining the objectives, developing the strategy and planning the measures for marketing. It is therefore necessary for a young enterprise to carry out the situation/environmental analysis systematically and in detail, which is usually time-intensive. The situation analysis comprises not only the current situation of the enterprise and of the environment, but represents at the same time an important estimation of possible development tendencies and trends.

For a situation analysis, many different methods can be applied. **Methods of situation analysis** are, for example, the various forms of *enterprise and capability analysis, market and competition analysis* as well as *environment analysis*.

#### 4.2.1.1 Enterprise and Potential Analysis

In the **enterprise and capability analysis**, an *analysis and identification of the internal strengths and weaknesses of the enterprise* are carried out. Even when writing the initial business plan, current strengths and weaknesses of the enterprise should be determined to be able to develop strengths and remedy weaknesses in the future. All areas of the enterprise can be significant when working out such an analysis, even though the situation analysis is used within marketing planning. Because of its customer- and market-oriented perspective, marketing represents an important element in the development of an enterprise-wide corporate strategy. With the help of a thorough enterprise analysis, bottlenecks are highlighted which must be taken into account when determining marketing objectives and the corresponding strategies and tools to be employed. Not all objectives and strategies can be realized at the time of analysis, but feasible measures must be worked out.

#### 4.2.1.2 Market and Competition Analysis

> *"I´m asserting that entrepreneurship and competitiveness are the two sides of the same coin: that entrepreneurial activity is always competitive and that competitive activity is always entrepreneurial." [Kirzner (1973), p. 94]*

An essential basis for the marketing process is provided by the market and competition analysis. **Market and competition analysis** entails the areas of *market research, market volume and market potential, market segmentation and positioning* as well as *competition analysis.*

Within marketing planning, one often talks about the significance of market analysis within the context of business planning or growth planning of young enterprises. However, the market analysis represents in principle only an isolated point in time in the description of the market and competition situation. Information and data are collected as a basis for entrepreneurial decision-making. This selective observation of the market must, however, be extended by **continuous market monitoring,** which is necessary, e.g., to obtain up-to-date relevant information about customers, competitors, the market and the overall business environment. With the assistance of a sound data and information base, young enterprises will be able to develop and realize target-oriented strategies and measures.

- Who are the customers of the enterprise?
- Who are the competitors of the enterprise?
- What is the unique selling proposition?
- How old are the products of the competitors?
- How old are the competition enterprises?
- What is the unique selling proposition of the product and the enterprise?
- Which is the relevant market segment for the product?

In principle, the same requirements which have to be met in the market and competition analysis apply when generating the business plan.

**Market Research**

It is important for start-up enterprises or young enterprises to know the market in which they intend to operate economically. Therefore, market research corresponding to their financial resources and know-how should be carried out. In some cases, not all the methods, tools and procedures represented in the following can be realized easily, or at all, by young enterprises. However, in spite of all existing problems, it is remains recommended even for young enterprises with limited resources to carry out at least some sort of market research, if only on a modest scale.

**Market research** is concerned with the *systematic acquisition and evaluation of data and information regarding the influencing factors and development tendencies of a defined market* taking into account the relevant general conditions [see Malhotra/Birks (2007)]. Market research can apply both to the *procurement* and the *sales market.* The aim of market research is to provide (as far as possible) objective information. On the basis of sound market research, statements concerning the size of the market volume, future potential and relevant shares can be made. These statements form the *basis for planning, implementation and control of concrete marketing measures,* and the greater the detail with which market research is carried out, the greater the precision with which the marketing tools can be applied. This area constitutes **market research in the narrower sense,** which should be distinguished from **market research in a wider sense**, which is also called *marketing research.* The following explanations are based on the understanding of market research in the narrower sense [Thommen/Achleitner (2003); Berekoven/Eckert/Ellenrider (2006); ESOMAR (2007)].

Market research makes use of systematic statistical methods for measuring and determining the required information about a market, ideally taking into account the quality-control criteria of *objectivity* (independence of the examined object from influences of the investigation subject), of *reliability* (reliability or accuracy of a measurement), and of *validity* (does the method measure what it should measure). [For quality criteria and their relevance see observations in Lienert/Raatz (1998); Bradley (2007).]

With relation to the method of data generation, market research can be divided into the forms of *primary market research* and *secondary market research*. **Primary market research** (field research) comprises *original interviews and surveys carried out by the enterprise itself* (qualitative and quantitative), *tests* (e.g., product-market tests) or *observations* (laboratory observations, field or practical observations). For young enterprises, the generation of primary data is highly significant, as during this process an intensive examination of potential target customers takes place. Possible concrete tools of primary research are, for instance, *mail surveys, personal interviews* (for instance, direct interviews of possible customers), *telephone interviews, laboratory observations* and *tests* [for other possible instruments see ESOMAR (2007).] In order to obtain primary information, from which a reasonable and representative conclusion for the target group of customers can be drawn, an effective survey not only requires a specific questionnaire and interview design but also the selection of a suitable sample of potential participants in the first place [Brace (2004)]. An analysis and interpretation of the acquired data may be done using methodically founded statistical methods such as, for instance, factor analysis or regression analysis [for doing quantitative market research specific textbooks should be consulted, e.g., ESOMAR (2007)]. Before engaging in primary research, however, some secondary market research should first take place [Berekoven/Eckert/Ellenrieder (2006)].

**Secondary market research** (desk research) starts from the basis of data already generated, which have not been produced originally by the primary research undertaken by (or on behalf of) the enterprise. Thus, it is usually less costly than primary research. However, it should be taken into consideration that access to other potential sources is also possible. Thus, secondary market research can make use of *enterprise-internal sources* as well as *enterprise-external sources.* Secondary information, therefore consists of data and information which have already been generated and sometimes analysed, and allows the enterprise to save costs as compared with primary research [Berekoven/Eckert/Ellenrieder (2006)]. **Enterprise-internal sources of the secondary market research** are (in already existing enterprises): *production and sales statistics, accounting information* or *primary market research studies carried out earlier* (which now serve as secondary information). Examples for **enterprise-external sources of secondary market research** are, for instance, *regional and national statistical offices, chambers of commerce, local and regional industrial development boards, internet, trade-fairs and trade-fair brochures, business journals, economic information services (e.g., ABI/INFORM), data bases, publications of research institutes and universities as well as daily newspapers and trade magazines.* Secondary market research is particularly recommended for young enterprises because of its low cost level, although it may occasionally be problematic to gather suitable information from secondary sources, especially in the case of innovative and complex start-ups operating in new sectors (e.g., high-technology). However, the occupation and in-depth familiarization with this difficult area alone may help to produce a clearer picture of the challenges of the market.

Market research can be carried out as an *enterprise-internal* as well as *enterprise-external* process. In the enterprise-internal market research, the employees of the enterprise or the founders themselves carry out the research. In the case of enterprise-external research, the enterprises can contract special market research agencies to carry out studies. These commissioned studies are, however, usually associated with high costs, which in most cases cannot be afforded by young enterprises. A more economical possibility would be to acquire already completed studies after having verified whether these offer any real benefit to the young enterprise. In particular, there are market research institutes and agencies with a special focus on a single market, with examples from the sector of information technology are *AMR Research* [www.amrresearch.com], *Datamonitor* [www.datamonitor.com] or *Gartner* [www.gartner.com]. These institutes represent sound information sources for enterprises for assessing, observing and forecasting market developments and trends in the IT-market.

General questions in this context are, for instance:

- How can the target group of the enterprise be defined?
- What are the demands and needs of the customers?
- How do the wishes of the customers develop?
- What do they buy?
- How do the customers learn about the products?
- How often do the customers buy a certain product?

All information is ultimately significant which supports the development of suitable marketing objectives, the strategic decision-process and the implementation of marketing policies. A market research study in the classical sense, which supplies data about the target groups as precisely and detailed as possible, is not always easily achieved by young enterprises for reasons of costs. Comprehensive product tests and interviews with the target group, organized in great detail, can often only be carried out by large, established enterprises or market research agencies. However, young enterprises are usually in a position to use the tools of market research to a certain degree in order to obtain information about the market, although this information is not always representative due to small sample sizes of field studies typically conducted by start-up enterprises. However, a study carried out by an established enterprise or market-research company does not always necessarily represent the market exactly and lead to a realistic assessment.

**Market Potential, Market Volume and Market Share**

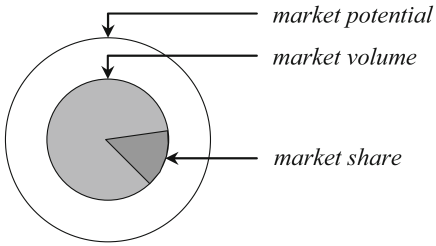
With regard to the formation of market segments suitable for the young enterprise, a precise differentiation between the concepts of market potential, volume and share is useful. The **market potential** indicates the *theoretical maximum size of the market,* i.e., expressed in the form of the maximum possible sales or the maximum possible turnover. The market potential reflects the maximum absorption capacity of a market, if all potential customers would fulfil their wants. Factors influencing the market potential are, for example, changes in sales prices or population development. The **market volume** designates the total current sales or the value of the total actual turnover of a product, a product type or a business sector *within a given period of time* (say one year) in a particular sales territory. The **market share** forms the smallest unit, i.e., the percentage share of an enterprise in the total market volume. This share can be measured in terms of quantity or value. When measured quantitatively, the share will, for instance, refer to the number of sold products of an enterprise within a period, measured against the total sales of the product in the business sector (e.g., Toyota passenger cars sold as new car registrations in Germany, measured against all new passenger car registrations in a year). In terms of value, the market share will be obtained through the achieved turnover measured against the actual total turnover in a business sector.

It is often problematic to assess the **market potential**, i.e., the theoretical maximum size of the market. An example is the market for mobile phones. Theoretically, the total world population with the exception of young children would have to be considered. It is, however, also possible that people have two or three mobile phones, so that the calculation of the market potential could only be approximated, based on certain assumptions. Compared to this, the calculation of the actual market volume can be simpler. According to estimates carried out by the technology forecasting company Gartner Group, the **market volume** of mobile phones in 2009 will be over a billion phones for the first time. However, the financial crisis may have a big negative impact on mobile phone sales in 2009/2010 with decreasing growth rates. While there may be signs of market saturation in developed economies there is continuing strong growth stemming from emerging economies like China or India (consider, for example, the growth rates of China Mobile).

A challenge in the determination of the market volume and market share lies in the demarcation of the relevant market according to the criteria of products, territory or time. In individual cases, the assignment of comparable or substitute products to a market can be problematic. It may also be difficult for an individual enterprise to acquire the relevant data and information for determining market share data.

Illustration 4-1 shows graphically the relationship between market potential, market volume and market share.

***Illustration 4-1:*** *Market potential, market volume, market share*



### Market Segmentation and Positioning

> *"Segmentation answers the question: which is (are) my target market(s)?" [Lodish et al. (2001), p. 1]*

In market segmentation, a large heterogeneous total market is divided into homogeneous market segments, with the purpose being to reproduce the needs and wants of the customers, who show a uniformity as great as possible, in a common market segment. This market segment should distinguish itself as clearly as possible from the other market segments. To carry out market segmentation a differentiated market research study, as well as well-founded market and competition analyses are required. Based on the industry, market and competition analyses, market segmentation and positioning are accomplished and build the fundament for managing market entry and devising an overall marketing strategy [Guiltinan (1999)]. To carry out the **market segmentation** as accurately and purposefully as possible, it is important to *know the behaviour of (potential) customers and competitors*. The more carefully the market segmentation is carried out, the more accurately market potential, volume and share can be determined.

A **differentiation of the total market** can be made according to various criteria. A systemization is, for instance, possible according to *socio-economic* and *psycho-graphic criteria,* as well as *criteria of observed purchasing behaviour.* **Socio-economic criteria** can be differentiated into *geographic criteria* (e.g., town, region, country etc.), *socio-demographic criteria* (e.g., gender, age, family status, household size, income, schooling, job etc.). **Psycho-graphic criteria** represent *general personality characteristics of the target group* (e.g., social orientation, attitudes, life style, expectations, values etc.) as well as *product-specific characteristics* (e.g., purchasing motives, product-specific attitudes and expectations). In addition, **emotional criteria** are increasingly gaining importance. The **criteria of the observed purchasing behaviour** of a group of consumers finally illustrate the different forms of *price behaviour* (e.g., price elasticity or sensitivity, high- and low-price behaviour, purchase of special offers), of *media consumption* (e.g., overall media use, what media, in what form, at what time and at what frequency), *choice of shopping location* (e.g., business loyalty, frequency) as well as criteria of *product choice* (e.g., brand loyalty, shopping frequency and quantity).

As regards the measurability of these criteria and characteristics, it should be possible to *determine the criteria empirically.* Moreover, *time stability* of segmentation data is important for the choice of appropriate long-term marketing strategies, so that the chosen criteria are valid for a certain period. It is particularly important that the empirical analysis be carried out against the background of economic cost-benefit relations.

The **positioning** of a product depends on the one hand on the product, its qualities, presentation and price. On the other hand, the strategic orientation of the enterprise is significant which predefines a positioning within the market segment. "Positioning answers the question: Why will someone in the target market(s) buy my product or service instead of the competition´s?" [Lodish et. al (2001), p. 1]. Positioning can therefore be achieved via *product positioning* as well as *enterprise positioning.*

**Competition Analysis**

Competition analysis comprises the generation of information about competitors focussing primarily on strengths and weaknesses, products, business operations, organization as well as aims and strategies. The purpose is to obtain a picture or a detailed impression of one's competitors as exactly as possible, to be able to anticipate possible actions and derive strategies and response measures. The information derived from the competition analysis can also be used to position the own enterprise and products.

The following tools and measures can be used to procure information about competitors:

- Trade-fairs and trade-fair contacts
- Analysis of internet pages
- Analysis of enterprise and product brochures
- Information from customers of competing enterprises
- Information from suppliers of competing enterprises
- Observation, analysis and derivation of competitors' marketing strategies and policies (price, product, promotion, place)
- Observation and analysis of advertising policy
- Trial orders and measuring of throughput times
- Product analysis, including reverse-engineering (process of comprehending and reconstructing the composition of an existing competition product through investigating functions, structures, materials, proportions etc.)
- Public and private credit agencies or information offices.

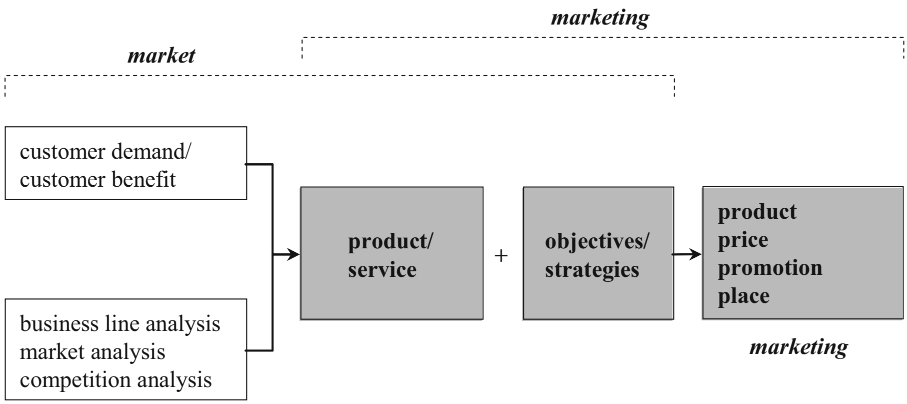
Young enterprises too, using simple means, can obtain acceptable information about the competition, even under tight time and finance restrictions. The relevance of competition analysis should not be underestimated by young enterprises, as the success of an enterprise becomes apparent only in the market when competing for customers. For young enterprises, it is recommended to establish a system for continuous competitor observation on the basis of their initial competition analysis. In large established enterprises, whole departments or teams are organized for this purpose (**business intelligence** or **competitive intelligence**).

### 4.2.1.3 Environmental Analysis

**Environmental analysis** in the wider sense of strategic management deals with the analysis of the external general conditions of an enterprise. [Johnson/Scholes (2007)] External conditions can, for instance, be *ecological, technological, economic, political, legal, cultural* and *social,* and may have varying degrees of relevance for a young enterprise. The collected data and information on environmental influence factors can serve to estimate the strength of their potential impact and their evolution over time. On the basis of their effects on the enterprise, marketing (as well as overall corporate) objectives, strategies and policies can be derived. A continuous observation is called **environmental scanning.**

Illustration 4-2 shows the relationship between market and marketing:

***Illustration 4-2:*** *Market and Marketing*




Data and information acquired within environmental analysis flow into the strategic planning of the enterprise and serve as basis for the decisions of the enterprise management. Within a customer- and market-oriented enterprise management, the information represents the basis for the planning of the marketing objectives, marketing strategies and marketing measures. Overall, external analysis of the wider and immediate market environment provides important inputs for the subsequent planning of marketing objectives as well as strategies and marketing mix decisions. Empirically, new and young enterprises seem to have less information about their market environment than large, established enterprise [Mohan-Neill (1995)]. In particular, they may rely more on information on their immediate market environment rather than making efforts to gather information within an analysis of the macro environment (e.g., political or cultural trends). Typical information sources used by young enterprises are industry-specific journals, contacts to immediate stakeholders – in particular customers and competitors. [e.g., Brush (1992)] The intensity of entrepreneurs' search behaviour for market information may depend on the perceived importance of the decision for which the information is gathered as well as on the degree of market turbulence and uncertainty about customers [Pineda et al. (1998); Sawyerr/McGee (2003)].

### 4.2.2 Planning of Marketing Objectives

Depending on the significance which a young enterprise attaches to marketing, the objectives of marketing can be assigned to the general corporate objectives of the enterprise or may be derived from them. The marketing objectives or aims then form the basis for the development of marketing strategies and operational marketing policies. The planning of the marketing aims is in particular based on the results of the situation and environmental analysis. The marketing aims have a controlling and coordinating function for the management of the enterprise. For the employees, they can provide orientation and a motivation stimulus. Basically, **marketing objectives** can be formulated as *economic* and *market-psychological aims.*

**Economic marketing aims** are directed towards the increase of the turnover, i.e., they try to influence sales quantity and sales price through instrumental goals. In contrast to young, small enterprises, large enterprises often also calculate their sales success based on contribution margin accounting (i.e., calculating the contribution of product lines or individual products to covering fixed costs of the production of goods and services) [see, e.g., Drury (2004) for contribution margin accounting based on product lines, branches or sales outlets]. The latter can also be useful for young enterprises to determine the profitability of individual product or service offers and to establish a relation between employed marketing instruments and the resulting success of the enterprise.

Economic marketing aims feature different characteristics than market-psychological aims. **Market-psychological marketing aims** are qualitative aims. They describe intended, purposeful adjustments of future purchasing behaviour of customers corresponding to financial aims behind the marketing efforts of an enterprise. Possible qualitative target values and *impact quantities* are *brand awareness, brand image, purchasing intensity, customer satisfaction* as well as *product, service or brand loyalty* the improvement of which may propel bottom line sales and turnover figures.

Irrespective of this basic systemization cited as an example, young enterprises can follow a mix of economic (related) and market-psychological aims and overall marketing objectives. Typical and frequently stated marketing objectives of new and young enterprises comprise, for instance, *the improvement of market position, market presence, price position, quality position* as well as *an improvement of the product and enterprise image* *or level of recognition (brand awareness)* [cf., for example, McDougall/Robinson (1990) for different generic types of market- and growth-related objectives at market entry and Meier (1998) for an interesting study of marketing objectives of Swiss start-up enterprises] The achievement of these aims can be realized by the employment of suitable strategies and tools of marketing. It is important for the formulation of concrete marketing objectives to take a stringent customer-oriented perspective, i.e., the customer occupies the centre in the process of developing adequate marketing objectives. (Like all objectives of an enterprise, also the marketing-related aims should be realistic and obtainable, for they only meaningful if methods for their achievement are also established. This means through the words of Antoine de Saint-Exupéry:

> *"A goal without a plan is just a wish." [Antoine de Saint-Exupéry]*

## 4.2.3 Planning of Market Entry

### 4.2.3.1 Market Entry Strategies

A well founded and target-oriented **market entry strategy** is usually of fundamental importance for the market success of a start-up enterprise. Many founders already neglect, however, the **market entry strategy** in the phase of developing their business plan. As soon as an exciting business idea exists and the business plan is formulated, method and time of the market entry are rather left to chance. Within the framework of the above situation analysis, it is necessary to identify, on the basis of the results of the market research carried out before, those market segments which promise a successful entry and growth path for the start-up. This should involve taking into account the associated opportunities and risks, as well as the specific strengths and weaknesses of the enterprise. The decision criteria for the assessment of the chances of success are, for instance, the attractiveness of the market in question and the relevant market entry barriers. The attractiveness of a market refers, for example, to market volume, market growth, industry and competition structure as well as customer potential. Important **market entry barriers** are, e.g., *enterprise size advantages of the competitors (economies of scale advantages), a limited access to financial or personnel resources, patents, access to distribution channels, switching costs for the customers* or *legal or institutional restrictions.* Generally speaking, there are many and diverse forms of market entry strategies. One can, for instance, distinguish between **traditional and virtual forms.** *The traditional forms* comprise niche (or focus) and differentiation strategies. *Virtual market entry strategies* occur via online-media, in particular through the internet.

From the traditional point of view, a market entry can be carried out by using the competitive strategies according to Porter [Porter (1998, 1999)]. [For a discussion of Porter's market entry strategies in the entrepreneurship context, see Allen (2003); also see Johnson/Scholes (2007) within the broader context of strategic management.]

Porter distinguishes between three **generic strategies**:

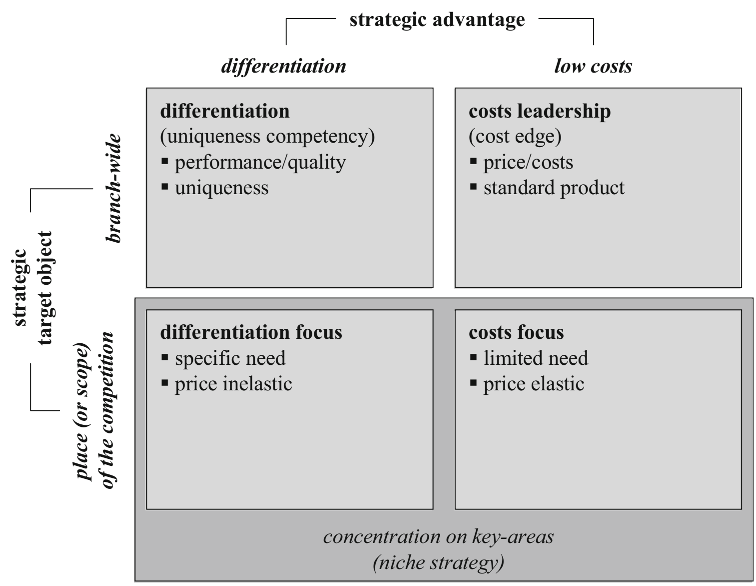
- Cost leadership
- Differentiation
- Concentration on key-areas or niche strategy (cost focus or differentiation focus)

A combination or alternation of cost leadership and differentiation strategies throughout the market entry process is reflected by a:

- Hybrid-strategy

Illustration 4-3 shows the relationship between the competition strategies according to Porter (1998, 1999)

***Illustration 4-3:*** *Systematisation of competitive strategies according to Porter*




A combination of several approaches by an enterprise is possible. However, the application of one approach already requires the employment of substantial resources and effort. For this reason, a combination of several strategies can be difficult, especially for start-ups or young enterprises.

**Cost Leadership**
The cost leadership or superiority is based on the *concept of the experience curve*. This approach reveals an empirical relationship between the change of direct manufacturing costs and the cumulative production volume over the course of time. Thanks to the collected experience in the production process, a decrease in (inflation-adjusted) production costs per unit is possible with increasing time-horizon.

As a competitive strategy, a *comprehensive cost superiority* over competitors is aimed at. This can be achieved through the realization of *economies of scale* (effects of decreasing unitized fixed costs). To yield competitive advantage, the unit costs of an enterprise should drop below the level of the most important competitors. This can be achieved, for instance, through the *investment* in *high production capacities* and corresponding increases in production efficiency. In this context, all opportunities for *exploiting experience-based cost reductions* are important, such as a tight control of variable costs and overhead expenses [Allen (2003)], as well as cost cutting in the areas of research and development, marketing and distribution. In addition, *process innovations* or *standardizations* are aspired to. Quality and service should, however, not be affected by the concept of cost leadership. **Advantages of cost leadership** are a potential *protection against strong buyers* and *also strong suppliers.* Cost leaders have the potential to fight off the five forces of industry competition as defined by Porter [see Illustration 4-3 above]. The **realization of competitive cost leadership** usually requires a *high market share* of the enterprise and a strict focus on cost efficiency across all operations [Porter (1999); Johnson/Scholes (2007)].

Young, innovative and growth-oriented enterprises may aspire to cost superiority, in particular through the employment of new process and production technologies, new materials or through novel organization and distribution concepts. These can help young enterprises attain a cost advantage over the competition. However, it is exactly in the area of new process and production methods and technologies that high capital investments will be required, which newly founded enterprises sometimes cannot raise. On the whole, the realization of a strategy of cost leadership is in principle difficult for young enterprises, due to their typical resource shortfalls [McDougall/Robinson (1990); also cf. Roure/Keeley (1990) and Brooksbank (1991) arguing that a strategy of differentiation may offer more chances for success than striving for cost superiority]. *Obtaining a substantial share of the market after market entry and increasing this share often requires high investments* as well as an aggressive price strategy with low sales margins. In the early phases of the enterprise development, it is also *not yet possible* to fall back *on sufficient experience in cost-cutting,* nor are reductions in *research and development expenses recommended,* as innovations are often necessary for generating growth. Enterprises usually chose a strategy of cost leadership in a later phase of the enterprise development, e.g., after having left a market niche. There are, however, also examples of success, where the market entry was achieved by following a strategy of cost leadership. Classical examples are retailers such as Wal-Mart and the discount grocery chain Aldi as well as IT enterprises such as Dell and Lenovo. Today, many

Chinese and Indian enterprises are following a strategy of cost leadership. In practice, a strategy of cost superiority at market entry can be viable for start-up enterprises operating in novel industry sectors where everybody suffers from the same disadvantages of small size (i.e., where there are no large, established competing enterprises with advantageous scale economies) [Allen (2003)].

**Differentiation Strategy**
The differentiation strategy aims at distinguishing the *enterprise from the competition.* The objective is the *creation of a unique profile* within the business sector of the enterprise. The concrete form of this uniqueness can, for instance, refer to the technology of a product, the brand name, the customer service or the distribution structure. Hence, differentiation does not have to be limited to the physical product. The aim of the differentiation strategy consists in a *sustained binding of customers* to the product and brand. At the same time, a *decrease in the price sensitivity* of customer demand may be achieved because of the unique features of the product and service offer. In contrast to cost leadership, the differentiation strategy does not presuppose a high market share, which can be rather impeding, as exclusivity is often the aim of differentiation. The uniqueness of a product or a service is therefore intended to generate a market entry barrier for potential followers [Porter (1999); Kotler/Keller (2006)]. In particular, there is also a question of recognizing and using existing trends in the market through marketing. Often, marketing aims at a differentiated benefit which is expected to appeal to the emotions of the customer.

The concept of the *Kieser Training AG* is an example of differentiation strategy, which the company applied in the sector of health-oriented cardio and strength training. In 1967, Werner Kieser founded his first fitness studio in Zurich, Switzerland. In the course of time, the concept of the fitness studio was, however, further developed into the concept of "Kieser Training". Its slogan is, "A strong back does not know pain". The differentiation from an ordinary sports or fitness studio is intended through a health-oriented strength training as a prevention and therapy service. One particular target group are older people. The differentiation aspect of a health-oriented strength training is also evident in the use of training machines, which were developed especially for medical applications in rehabilitation programmes. The concept of the Kieser training thus integrates the areas of fitness training, rehabilitation and prevention.

Young enterprises, in particular, may also achieve differentiation via their corporate identity, i.e., their conception of themselves or their appearance. An enterprise's **corporate identity** contains its *corporate image,* the intended perception of the enterprise, i.e., an enterprise image, the *corporate design* (CD), the audio-visual characteristics of the enterprise (e.g., jingles and specific symbols or colours related to the enterprise e.g., IBM, nicknamed the "Big Blue" for its corporate colour), *corporate communication* (CC), as well as overall *corporate behaviour* (CB) or enterprise culture.

One **risk of the differentiation strategy** consists in that the *differentiation is not carried far enough*, or the *differentiation is not perceived as such by the relevant group of target cus-*

*tomers.* In addition, it should be checked how fast the introduced differentiation can be imitated by the competitors, how unique advantages and resources may be defended, and which protection rights may be applicable.

**Niche Strategy**

When a niche strategy is applied, a *concentration on selected target groups*, market segments or parts of a product range takes place. Moreover, the *demarcation of a geographical market* is possible. Niche strategies offer the chance to generate profits, even with focussing, which is achieved either by a *cost lead related to the pursued target* or through a *high degree of differentiation*. In a niche, both variants can be realized simultaneously, thus, this strategy type represents a combination of the two generic strategies discussed above. A possible negative aspect, however, might be the conflict between profitability and maximizing turnover, as the niche market share represents a limitation as compared with the total market [Porter (1998, 1999)]. As a successful example in this context, the biggest European low-cost airline *Ryanair* (Ireland) can be mentioned. Ryanair started in 1985 with a niche strategy. With only 57 staff members and one 15 seater turboprop plane, Ryanair at first concentrated their offer on just one route (South-East Ireland to London Gatwick). As one of the lowest cost-operators in the airline industry, Ryanair today seems to be a cost leader rather than a focuser. Because of the usually limited financial and personnel resources as well as the critical time factor, the realization of a niche strategy offers itself to young enterprises. The product offer itself, as a *special or individual product*, should be specifically tailored according to the of the market niche and the customers. In this context, one also talks of a **single niche strategy** [Kotler/Bliemel (2001); Kotler/Keller (2006)].

When following the niche strategy, one should ensure that the enterprise has a sound, in-depth technical knowledge of the niche in question. It should be checked with this type of strategy how easily other producers and vendors can penetrate into the niche and whether the niche represents a market which makes the survival as well as the growth of the enterprise possible on a long-term basis (bearing in mind the possibly low potential sales volume of niche markets).

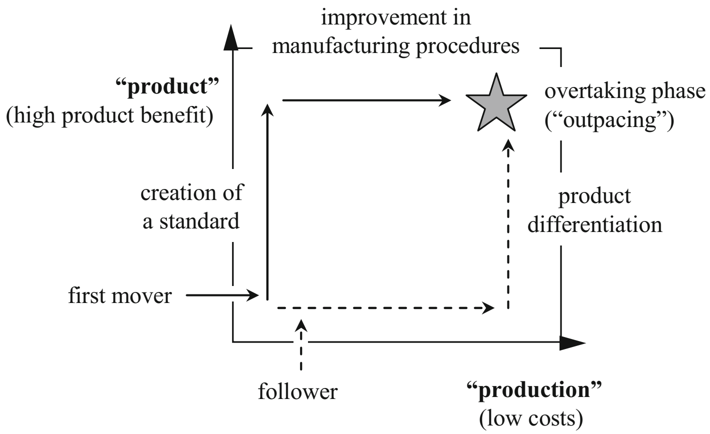
The three competitive strategies according to Porter can give an enterprise a general orientation framework and assist it in finding a core strategic direction for the business. As regards their practical implementation, however, a step-by-step process of strategy formulation and implementation with feedback loops would usually be preferred, in particular for start-up enterprises and when operating in novel industry sectors where strategy adjustments will be necessary in the course of time [cf. Johnson/Scholes (2007)]. Market strategizing is not a question of adapting to a static environment, rather, strategic marketing (as well as strategic management in general), implies the interaction with a dynamically changing environment that is both an evolving point of reference for the enterprise as well as a set of conditions which may partly be actively influenced and shaped by pioneering entrepreneurial activity. [Consider, for example, the pioneering sector building activities of e-commerce start-ups in building the new economy; cf. Aldrich/Baker (2001).]

Strategic approaches in recent literature, in particular, make a conscious effort to distance themselves from the earlier studies of Porter. In this context, Kim/Mauborgne (2005) with their book "The Blue Ocean as a Strategy" could be named as an example. [See also the related concept of institutional entrepreneurship where entrepreneurs actively build new industries, including novel regulatory frameworks, on the basis of innovative products and services; e.g., Maguire et al. (2004) in the emerging field of HIV treatment services.]

**Hybrid-strategy**
The differentiation or cost focus strategies, whether they are employed industry-wide or within a niche, can be described as Porter's generic strategies. Enterprises were advised to choose one of the strategies to gain a strategic advantage, i.e. following a more or less a static, "either or" strategic choice. But today, against the background of a globalised and dynamic market, it is necessary to be more flexible than merely focussing on cost efficiency or differentiation. Therefore, the exclusive use of generic strategies might not be the best option. It seems to be better to recommend not only a single generic strategy but a combination of both as a company's main strategy. This concept is called a hybrid-strategy. The use of a hybrid-strategy depends predominantly on the time of market entry, in particular whether the enterprise is a first mover (pioneer) or a follower within the industry segment to be entered [For further information see chapter 4.2.3.2].

As an example a first mover (pioneer) enterprise should create a specific quality standard for its product, delivering a high product benefit to target customers. In Porter's terminology this is a differentiation strategy. After setting a standard for one's product or within the industry the enterprise should concentrate on improving its manufacturing processes to gain a cost advantage; i.e. pursuing a cost leadership strategy (e.g., in order to preempt potential competitors that may contest the market position of the first-mover enterprise by competing on price based on large, scale-efficient, production volumes). Later it maybe wise to focus on high product benefits again. Differentiation and cost leadership strategies may alternate one after another. Essentially, it will be important for first movers to be aware of potential followers and adapt their strategy correspondingly. If a standard was set by the first mover, a follower should fist concentrate on a cost leadership strategy and only afterwards pursue strategic differentiation to outpace competition, namely the initial first mover. However, it is important to mention that if a first mover missed to set a standard with its product, the follower might go for a differentiation strategy to set its own standard right away. The most important issue in this context will be to know whether a company can outpace competition by applying an inverse strategy combination relative to the competitor it is contesting. See Illustration 4-4 summarizing the strategy paths just discussed [Illustration according to Müller-Stewens/Lechner (2003)]. As an example, Sony has often strived to set a standard with its new products. This strategic approach worked fine in the 1980ies and early 1990ies with the Walkman but in the context of digital mobile music devices the company failed to set a standard. Here Apple was able to step in and to set a main standard with its iPod. In general Apple uses hybrid-strategies in different markets to gain superior market positions for its lead products. Elsewhere, Google was able to set a virtual industry standard with its search engine, as well as Amazon in the context of e-commerce, eBay with its auction marketplace, and Facebook in terms of community-linkage. An advice for young enterprises with substantial growth aspirations is to try to set a standard in their line of business if they are first movers or early followers.

***Illustration 4-4:*** *Outpacing strategies*




**Strategy of Benefit Innovation**

In difference to the competition-based strategies of Porter, which traditionally bank on the analysis of existing industry structures, Kim and Mauborgne formulated the rather more proactive *strategy of a benefit innovation*, which involves the creation of new markets and market segments, in which competitors are not (yet) active, and demand has still to be created in the first place. In a graphic description, they distinguish between a red ocean as the known market and a blue ocean as the unknown market. In the **red ocean**, a *ruinous (price) competition* reigns between the competing enterprises of an industrial sector. Competitors in static structures meet each other as opponents. In contrast, *new markets are to be opened up through creative innovative strategies* in a **blue ocean.**

Illustration 4-5 describes strategy forms for red and blue oceans. [Kim/Mauborgne (2005)]

***Illustration 4-5:*** *Strategies for red and blue oceans*

| ***strategies for red oceans*** | ***strategies for conquering blue oceans*** |
|---|---|
| traditional thinking | innovative, entrepreneurial thinking |
| compete in existing market space | create uncontested market space |
| beat the competition | make the competition irrelevant |
| exploit existing demand | create and capture new demand |
| make the value-cost trade-off | break the value-cost trade-off |
| align the whole system of a firm's activities with its strategic choice of differentiation *or* low cost | align the whole system of a firm's activities in pursuit of differentiation *and* low cost. |

According to Kim and Mauborgne, the concept of the blue ocean with its *strategy of benefit innovation,* based on a holistic approach, *represents more than just an innovation.* Already at the time of market entry of an enterprise, this strategy aims in all its activities at a win-win situation of gains both for the customer and the enterprise itself. **Strategies for a successful conquest of blue oceans** are characterized by the criteria of *focus, divergence* (i.e., defining one's own profile against the competitors), as well as by a convincing *slogan* [Kim/Mauborgne (2005)]. Note though that also Porter's five forces of industry structure, on which competitive strategies are based, may be used proactively by managers and entrepreneurs (e.g., through raising entry barriers for others and restricting buyer power by investing in brand development and raising switching costs).

Competition-based or innovation-oriented theoretical concepts can help growth-oriented enterprise founders in particular, to find a strategic direction for their business which is suitable for them. Irrespectively, it is always recommended to have a clear and unequivocal strategy for making a successful market entry. Otherwise, there will be numerous risks of remaining unsuccessful in the market, as the young enterprise does, for instance, not reach the aspired market position or is unable to carve out a unique profile.

#### 4.2.3.2 Timing of Market Entry

As a core element of a start-up's market entry strategy, the moment of the market entry and the sequence order of roll-out times on selected markets are crucial. In technology-intensive, fast growing markets in particular, the right moment of entry can be decisive for the market success of a young enterprise. At the same time, the enterprises can basically choose between a pioneer strategy and a follower strategy. Within the context of the follower strategy, it is also possible to differentiate between *early* and *late followers.* [For the strategic reasoning and actual choice from different market entry modes in the case of entrepreneurial ventures in emerging versus developed markets see, e.g., Levesque/Shepherd (2004).]

**Pioneer Strategy**

The pioneer strategy is oriented towards an early introduction of a new product or the use of a new production technology in order to generate competition advantages over the (potential) competitors. Theoretically speaking, the pioneer strategy aims at creating a temporary monopoly position, e.g., by achieving a technological lead. The entrepreneurial pioneer has the possibility of realizing the greatest *economies of scale* and may also pocket substantial pioneer rents from her/his monopoly [Kotler/Bliemel (2001); Brouwer (2000)]. The advantages of a pioneer strategy are, for instance, achieved through patents and other protection rights, the generation of image advantages and brand formation as well as the establishing of standards. However, a product change can be associated with high switching costs for customers. Applying a pioneer strategy can also bring disadvantages for the enterprise. There may be uncertainties with regard to the further technological development, the development of demand or customer needs [Brouwer (2000)]. In addition, the creation of a new market by the pioneer can also benefit followers (free-rider-effect). Moreover, the image of the young enterprise can be damaged, if not fully matured products are introduced too early to the market.

To create sustainable long-term pioneer advantages is a challenge for enterprises and can in practice only be achieved with difficulty. It is necessary to aspire to a constant improvement and extension of the pioneer advantages to be in a position, for example, of actively erecting market entry barriers (e.g., by occupying vital distribution channels or raising switching costs for customers via novel product features or additional services). Then it becomes evident that the pioneer strategy is not always necessarily advantageous. Neglecting to create succeeding innovations can become a risk for the pioneer. The former computer manufacturer *Commodore* may be an example. With their home computer *Amiga*, an innovative computer platform was created in the 1980s. Considering the conditions of the time, *Amiga* had extraordinary multi-media capabilities as well as an efficient pre-emptive multitasking-operating system. It is, however, true to say that these pioneer advantages in the home computer sector were not be utilized to generate a sustained market position. Among other missed opportunities, the company neglected to further-develop sustainably the graphics technology of the computer and to create new (succeeding) innovations to be able to hold their own against the competitors such as, for instance, *IBM* or *Apple*. In addition, *Amiga* adhered to the image of a games computer, so that it was often not recognized as a serious work computer in the business world. The enterprise *Commodore* was not able to exploit the pioneer advantages of the Amiga system and, as a result, the enterprise went into insolvency in the middle of the 1990s.

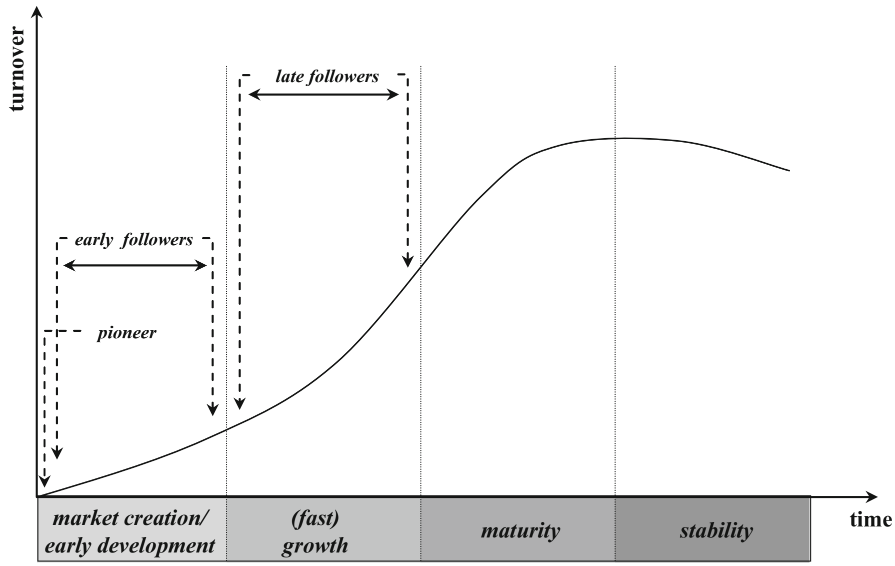
The decision for a pioneer strategy requires comprehensive environment and enterprise analyses. The application of a pioneer strategy for a newcomer to a business sector can only be recommended in the case of comprehensive experience and technological competence. Entrepreneurial practice has shown that a pioneer strategy is mainly more advantageous than a follower strategy, when business sectors are characterized by high dynamism and short innovation and product life-cycles.

The tremendously fast development dynamism in the internet sector has shown that it has become possible for enterprises to realize pioneer advantages, also over a longer period of time. In the online book-retailing business, thus *amazon.com* has succeeded in achieving a pioneer role and long-term forerunner advantages through a fast market entry and short development times of products and services. *Amazon* was in a position to employ new technologies quickly, and to profit from them. With *Amazon* the customer is, for example, already in a position to gain a digital insight into the content of certain books according to the principle of "search inside the book", before buying. So far, this has however only been possible for a relatively small number of books. However, the technology exists and can be further developed, exploited and marketed, e.g., by selling not only whole books, but also individual pages or chapters in digital form. This approach means a detachment of the content in its entirety from the physical product of the book.

**Follower Strategy**

The market entry of followers can occur relatively quickly after the pioneer or at a later moment in time. Illustration 4-6 shows according to Buchholz (1998) that on the basis of the market life-cycle model, *early* followers enter the market within the market creation and early development phase or in the transition to the growth phase [also cf. Doyle (1998), p. 158)]. The entry of *late* followers can be possible within the entire growth phase or also during the maturity phase, although in this case tendencies of market saturation may already be recognized in the market.

**Illustration 4-6:** *Market entry points in market life-cycle*




*Early Followers*

The strategy of early followers is very similar to that of the pioneer and the same general business conditions can be assumed. The uncertainty of the future development of the market is still relatively high, although possibly slightly less when compared with the pioneer strategy. A market entry situation without competitors can no longer be assumed; rather, it is to be expected that a mutual relationship between pioneer and followers will develop, in particular in the overall development of the market and its regulatory framework [Remmerbach (1988); vd. Ven (2005)]. While it is true to say that the follower does not usually achieve a temporary sales monopoly position, an early follower can reach a quasi-monopoly position given a sufficiently large market and a product shortage for the pioneer as a result of too low initial production capacities (for such supply-side shortages are relatively common in new, rapidly growing markets). Moreover, the early follower benefits from the investments of as well as the experiences made by the pioneer and utilizes them within his own strategy. One can learn from the mistakes of the pioneer. Thus, it is possible to unite within the follower strategy specific advantages of the pioneer strategy with those of the follower strategy. Thanks to the first recognizable effects and reactions of the customers, the early follower has better chances for a more effectively tailored marketing strategy. Of course, possible market entry barriers of the pioneer represent a danger for the early follower, e.g., in terms of higher economies of scale and corresponding lower sales prices

[Remmerbach (1988); Kotler/Keller (2006)]. The question is whether in some cases the decision of an early follower to enter the market later on is a deliberate and purposeful decision in order to observe and analyse the market development and the market entry and product roll-out of the pioneer and to learn from any mistakes, or whether the early follower was just not fast enough to become a pioneer.

*Late Followers*
The market entry of the late follower may occur years after that of the pioneer. In the market growth or stagnation phase, there might have been reached an almost complete stability in terms of the production and product technologies employed and the overall market situation. In a maturing market, it is much easier to estimate the (remaining) total market potential. Thus some uncertainties may decrease, which are still part of the typical pioneer strategy. The technological and innovation-specific investments and the associated experiences of the pioneer and the early followers have resulted in diminishing technology and market risks for the late followers. As a rule, it is a deliberate decision of late followers to wait and enter the market at a late moment in time. The advantages for late followers may be that they have observed the competitors over a longer period and were able to learn from their mistakes. It is also possible to create own strengths from weak points of the competitors and to build a competitive edge. In addition, the late follower can benefit from the market entry of the pioneers and early followers (e.g., as their marketing and advertising efforts have created a mass market which may now be served also by late followers). A disadvantage of the late follower strategy can lie in the market entry barriers built up by pioneers and early followers. At the same time, the market potential may already have been absorbed to a large extent by the competitors, and the customers can already have formed specific product preferences and a brand loyalty towards them. (An example for a late follower is the German discount grocery chain *Lidl*, which took up the concept of the pioneer *Aldi* and applied it successfully.) [For the market entry of young enterprises see also Boersch/Elschen (2002) as well as Allen (2003).]

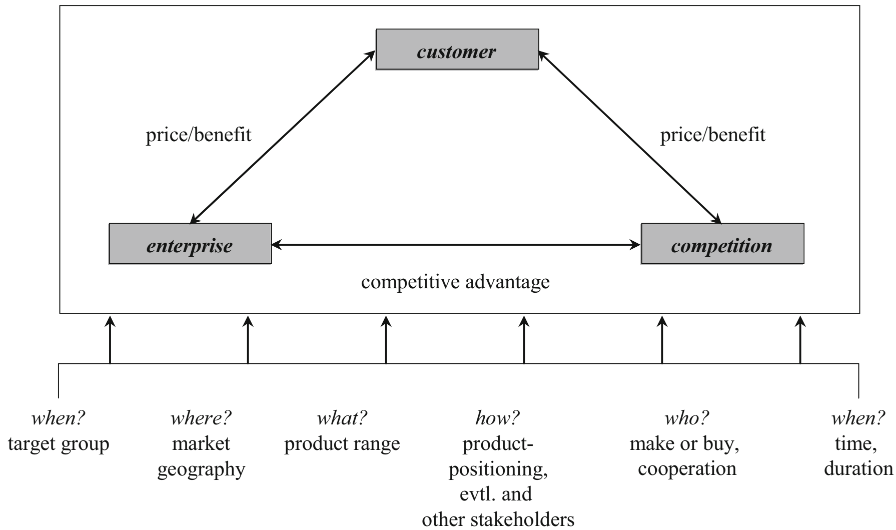
### 4.2.4 Planning of Marketing Strategies

**Marketing strategies** form the (primary) *guiding framework* for decisions regarding the employment of operational marketing instruments. In general, marketing strategies determine the market success of an enterprise in harmony with the overall strategy and the previously defined objectives of the enterprise. Through the generation of different strategy options as well as the evaluation and selection of a strategy, possible market-related effects are to be made transparent and more easily assessable. *Marketing strategies should be planned long-term*, for strategic marketing as well as product decisions have a fundamental, long-term significance for the future growth and survival of new enterprises, and it is difficult to correct strategic decisions subsequently [Szyperski/Nathusius (1999)].

From the theoretical point of view, there is a wide spectrum of concepts in the area of marketing strategies. The forms of possible marketing strategies are so many and diverse that they cannot be discussed here in detail. Depending on the systemization taken as a basis, various strategies can be assigned to marketing. There are, for instance, strategies for market entry and market growth, market positioning and brand creation as well as pricing and competitive strategies. Classical concepts for a systemization of marketing strategies are, for instance, the product-market matrix of Ansoff or the competitive strategies of Porter (see above).

Illustration 4-7 shows an example of the dimensions of a marketing strategy. [Nieschlag/Dichtl/Hörschgen (2002); Müller-Hagedorn (2003]

***Illustration 4-7:*** *Dimensions of marketing strategies*




Irrespective of which of the many and diverse concepts are chosen by the founders as a basis, it is ultimately the specific practical necessities and specific characteristics of the enterprise as well as of the market and the customers which have to be taken into account when developing a marketing strategy. Such marketing strategies, which have evolved from practical conditions, can nevertheless be unconventional and novel. In particular, they may well diverge from previous theoretical concepts (targeted at large, established enterprises), because the resource poorness of young enterprises in terms of time, personnel and finance. Therefore, a rapid and successful realization and high efficiency of the marketing strategy are decisive with respect to the target customers.

Within this context, it is important for founders to adhere to a customer or market-centred orientation of the enterprise. Within the enterprise, it is essential that the marketing strategies and instruments chosen by the founders or the management are also communicated to the employees, so it will be possible to achieve a high level of identification with and commitment to the enterprise and a stronger dynamism in the realization of the planned strategies and measures. Outside the enterprise, marketing strategies serve to generate a unique profile of the young enterprise, in particular in the eyes of customers. In this context, marketing strategies essentially answer the question: Why should the customer buy the product or the service of my enterprise? The perceptions, views and needs of the customers should therefore fundamentally shape the marketing strategy of young enterprises.

Marketing strategies can have their origin both in a consciously anticipated and purposeful approach of the founder or management team and in more-or-less unconscious marketing experiences. Especially in young enterprises, marketing strategies are often not planned deliberately and systematically in advance, but are the result of already employed operational marketing measures and the prior marketing and industry experiences gathered by the founders. [See Shane (2000) for the case of market entry strategies and Delmar/ Shane (2004b) for general market-related planning in emerging enterprises.]

It is, however, useful if the enterprise founders already at an early stage gain knowledge about different strategic marketing options as well as their features and effects. For a brand strategy it is, for example, important to know that brand creation is not a one-off action but a complex sustained process with many pitfalls. The brand success of the cult drink *Red Bull* is above all due to the sound marketing knowledge and experience of the founder Dietrich Mateschitz. He has shown that by a targeted and creative employment of marketing strategies and tools it is possible to build up a brand in a hotly contested market and lead it to a sustained success.

The example of *Red Bull* illustrates how important it is to achieve **real customer focus and orientation** and to know the needs and wants of customers. In this context, it is in particular the generation of “many small positive details” which are important in market-based strategies. [See, for example, the marketing and customer service strategy of *FedEx* which generates customer benefits and competitive advantages from numerous details of the logistics processes underpinning its delivery service; cf. Johnson/Scholes (2007).] In many cases today, a basic degree of customer service can be assumed which the customer expects as a minimum requirement. It is not only the simple satisfaction of his/her needs through the benefits created by the product that is important [cf. the possibilities for so-called service augmentation in differentiation strategies; cf. Kotler/Keller (2006)]. The **buying experience** and **care of the customer,** i.e., *delivering an individual customer service* should be taken into consideration. Here small details can generate great differences in the customer’s perception. The very first impressions and contacts with the products or services as well as with the enterprise itself, are of the greatest importance, as from the perception of small details conclusions are drawn for the services, products or the enterprise as a whole, mostly on the basis of a *cognitive comfort.* [A typical example are tangible cues (e.g., the attire of employees) used by customers of new services to assess the overall quality of the service; Zeithaml/Bitner (1996)]. If, for instance, the doorknob of a restaurant is dirty, or the reception of the customer by the restaurant personnel is unfriendly, this can already have an effect and produce negative expectations regarding the overall quality of the food. Conversely, small positive details produce or confirm positive expectations of the customer towards the products and services offered by an enterprise. In particular, the first contact is therefore of crucial importance. For this reason, a **strategy for the first contact with customers** should be developed (as a part of the marketing strategy) with the aim of generating as far as possible *positive first impressions* and to be in a position of utilizing these impressions in the further course of business relations.

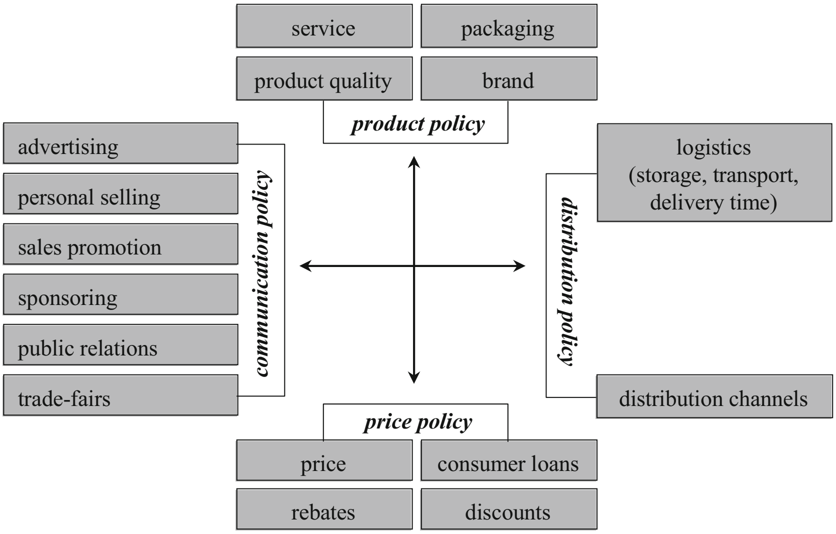
A clear demarcation between the overall marketing strategies and the different instruments of the marketing-mix serving to implement them is not always possible. The transitions are partly fluid and there is also an occasional overlapping. Pricing decisions comprise, for instance, both strategic and operational aspects. The same applies to product positioning as a strategic element within the framework of the product policy.

### 4.2.5 Planning of the Marketing Mix

The classical division of marketing tools in the form of the **marketing mix** goes back to Jerome McCarthy (1960), who carried out a systemization according to the *4P*, **product, price, promotion** and **place**. [Hansen/Bode (1999); Doyle (1998)] The four Ps relate to the four strategic elements of the marketing mix: product policy, pricing, communication, and distribution.

Illustration 4-8 shows an example of the relationships between product, price, communication and distribution policies within the overall marketing mix.

***Illustration 4-8:*** *Marketing mix diagram*




Like established and mature businesses, young enterprises also have the possibility of selecting suitable tools of the marketing mix for their specific purposes. However, time and resource shortages often impose restrictions on the possible application of individual tools.

The marketing success is usually not achieved by using one single marketing tool, but through a target-oriented selection and combination of different measures [Doyle (1998); Kotler/Keller (2006)]. The well-known Swedish furniture company *IKEA* can be quoted here as an example for a successful combination of marketing tools [cf. Johnson/Scholes (2007)]. This enterprise offers to its target customers a style of home furnishing as a special living experience in its advertising spots, ads and catalogues with the slogan "*Living begins at home*". The possibility to construct and create one's own living space coupled with an attractive price-performance ratio is designed to motivate the target group to buy at *IKEA*. For the potential customer, a visit to the furniture store is expected to become a living experience through the creative product design and the customer-based composition of kitchen, dining and bedrooms. There are also many and diverse additional benefits, such as a child-friendly environment and an integrated catering area and store restaurant which have a positive emotional impact on shoppers. In sum, *IKEA* succeeded in generating a unique profile and developing a clear differentiation from its local competitors in many different countries world-wide.

#### 4.2.5.1 Product and Service Policy

Guiding questions with regard to the product and service policy are: Which services and problem solutions are to be offered in the market and how are these to be developed? Already at the stage of product development, the specific customer needs should be considered in order to obtain a marketable, customer-oriented product. For some young enterprises it can also be recommended to involve the customers (in particular potential lead and heavy users) directly in the product development process. If the customer plays a central role in the design of the product, this is then also reflected in the marketing plan. As the example of the furniture company *IKEA* shows, the product is adapted to the demands of the customers. For young enterprises, this approach is highly significant, as they are often in position to react more flexibly to customers' needs and wants than larger established enterprises. As far as possible, young and small enterprises should take individual care of the customers in order to achieve a high level of customer loyalty. [As an example of possible marketing practices to retain customers in the case of small firms in the tourism industry see Coviello et al. (2006).] Achieving and maintaining a high level of customer loyalty may be useful for many reasons, for example, it is less costly to keep existing customers than to win new ones or because loyal customers may be less price-sensitive and willing to pay higher prices [for the latter see, e.g., Chaudhuri/Holbrook (2001)].

The creative possibilities when developing the product policy are numerous. Some examples for the instruments of product policy are:

- Product quality
- Extended benefits, service augmentation, after-sales-service, guarantees
- Marking or positioning of the product as a brand
- Packaging

There is the possibility for young enterprises to differentiate themselves from other competitors by producing a special product quality and to offer extended benefits to customers. For example, such benefits may refer to the following **product drivers** of utility [Doyle (1998, 81)]:

- Performance of the product (e.g., capacity or speed)
- Features
- Reliability (i.e., the likelihood of customers having problems with a product)
- Durability
- Serviceability (availability of service facilities, e.g., for repairs)

These product-related drivers of customer benefits may be supplemented by other drivers related to additional services to be offered, to the enterprise's personnel and to branding [i.e., services, personnel and image drivers; Doyle (1998)]. Today, the offer of extended benefits is becoming more and more important in markets with high competition intensity. Often, there are also legal obligations to provide certain customer benefits, e.g., in the form of guarantees. In addition to such obligations, the enterprise must decide which after-sales or other extended benefits are to be provided, to what degree and for what period. In this context, an essential question is whether this service portfolio is to be made available free of charge or is subject to a fee.

However, not only customer-specific services are important for young enterprises. The design and the manufacture of individual products for customers through *mass customization* can be beneficial for young enterprises. **Mass customization** means the adaptation of a product to the special requirements of a customer using the tools of mass production. In the concept of mass customization, *a combination of the advantages of job production* (individual customer needs for the product and its properties) with the *advantages of mass production* (economies of scale and scope through standardization) is achieved. The advantages of this concept consist in that individual products can be produced at the costs of mass production thanks to technological progress. It will be possible to individualize today's mass products, as, for instance, clothes, cars or furniture, according to the specific demands of the customers. This will require changed or new marketing strategies and concepts. Brand names may loose their importance, for example, as products and services are offered predominantly individualized [Pine (1999); Piller (2006)]. A specific know-how in their relations with the customers is often attributed to young enterprises, and this knowledge could flow into the development of new product and process innovations and bring us step-by-step closer to the realization of the mass customization concept. Regarding possible problems in the implementation or acceptance by customers, alternative strategies should be developed which would channel and exploit this know-how in a different way.

In branding, it is a special challenge to differentiate one's product through individualization from the mass of similar products. The available possibilities are numerous and diverse. Uniqueness can, for instance, by achieved by the design of the product or an original promotion. Well-known examples for a particular design, associated with a claim to high quality and technological innovation, are products of the companies *Bang & Olufsen, Bose* and *Apple*.

**Product positioning** defines and describes the advantages over competition products. Product positioning is closely related to other ingredients of the marketing strategy, in particular to market segmentation and the definition of target groups. "Once a segment is chosen, the firm has to seek to build a differential advantage which will make its offer preferred to those of competitors" [Doyle (1998), p. 64]. Product positioning is to be seen in association with the general positioning of an enterprise with the aim of creating a unique enterprise profile. The generation of a sustainable, reliable reputation and a positive image of the enterprise are important here. Within the narrower framework of product positioning, the building-up of a brand ranks highly. Product brands or branded services imply an aspect of quality presumption. A possible aim may be to equip the branded article with a product advantage which goes beyond the objectively examinable product characteristics. This approach is intended to generate specific buying preferences. In an ideal case, the brand name represents the positioning and philosophy of the enterprise. As the example of *IKEA* shows, the enterprise itself can represent a brand which implies a quality assumption.

In the case of consumer goods, a customer-specific attractive packaging can be very important. From the functional point of view, packaging serves first to protect and facilitate transport of a product, taking into account the respective environmental recycling regulations of a country. However, packaging should also be employed purposefully as a *differentiating tool* and to *generate a desired image.* The packaging can already contribute to a specific brand appearance of an enterprise. It is intended to stimulate the interest of the customers and to encourage them to take the product into their hands. To develop the product packaging strategy, again the **AIDA-principle (a**ttention**, i**nterest**, d**esire**, a**ction**)** can be employed**,** which – in the packaging context – describes the complete process ranging from the steering of the consumer to the product itself to the final purchasing action. In analogy to product development, product packaging is usually subjected to market research, development and testing processes. Product packaging can comprise the following properties or functions:

- Function of explaining the product
- Function of differentiating product to generate attention
- Graphic description of the customer benefit of the product
- Presentation of enterprise philosophy or image
- Environmental function through the use of recyclable materials

### 4.2.5.2 Pricing Policy

**Pricing (or price) policy** deals with the crucial question at which sales prices an enterprise must offer its products and services so that it can cover its occurring costs and make a profit on a long-term basis. However, the prices are not only influenced through the costs of the enterprise, but also by customers and competitors. “The fundamental objective of business strategy is to offer customers enhanced value so that prices can be raised substantially over costs. At a minimum, the aim is to achieve volume or market share gains without eroding profitability” [Doyle (1998), p. 227]. It is important for young enterprises to have a long-term pricing policy which facilitates a consistent communication of sales prices to the customer, taking into account the strategic orientation of the enterprise. An essential factor is a consistent positioning, e.g., either as a high-price supplier or as a low-price supplier. Changes in this area require some effort and will lead to a change in the perception of the enterprise in the eyes of the customer. In the introduction phase of new products in particular, pricing is an important, but sometimes difficult process, as frequently no experience values are available.

Essential measures or tools of the price policy are:

- Sales price of products/services
- Rebates and discounts
- Terms and conditions for consumer loans etc.

The employment and combination of the individual tools depends on many different factors. Selected factors influencing pricing decisions are, for instance:

- Market situation and power balance between suppliers and customers (buyer's or seller's market)
- Competition situation (Polypolistic, oligopolistic or monopolistic market)
- Supply and demand situation of a product (possible excess of supply or demand)
- Novelty degree of product
- Price elasticity of demand for product

Starting from these influencing factors, the pricing can be demand-, competition- or cost-oriented. Within value-based pricing, the price can also be fixed on the basis of the product benefit for the customer. An important input for developing an adequate price policy is a thorough market and competition analysis. From a costing perspective, an essential factor for determining the minimum price (as a lower price limit) is the knowledge about the anticipated cost structure (in particular fixed and variable costs) and sales volume. In order to be able to measure possible reactions of customers, entrepreneurs should try to determine the **price elasticity (or sensitivity)** of demand. This indicates how strongly the demand for a product will change in percentage terms as a response to a certain relative price increase or decrease. The practical implications of price elasticity lie in the possibility of predicting the effects of price changes of a product or service on the turnover of the enterprise.

As a basis, we assume the following theoretically simple function:

*Turnover* = *price* (p) * *quantity* (q)

The demand of customers (in monetary units) then corresponds to the product of sales price times bought quantity, which, from the point of view of the enterprise, results in the turnover generated by a product or service.

A defined change of the price (p) leads to a reaction of the demanded quantity (q). This possible reaction of the quantity can occur in different ways, and the price elasticity indicates the total effect. The basic forms of price elasticity of demand are *elastic* (quantity change greater than price change), *inelastic* (quantity change smaller than price change), and *iso-elastic* (quantity change equals price change). In addition, there are some forms which have rather to be treated as special cases, such as *completely inelastic* (constant quantity in case of price change) and *completely elastic* (no demand in case of price change). To clarify further, an example of an elastic and an inelastic demand reaction at a price increase can be quoted:

**Elastic Reaction**
Let us assume that an enterprise increases the price by 10 percent with a consequent decrease of the demand of 30 percent. As result, the total expenses of consumers for the product and the enterprise's turnover apostatize. This reaction can be described as *elastic.* The price increase of the champagne manufacturer *Rotkäppchen* for the product *Mumm* champagne can serve as an example. In 2004, *Rotkäppchen* introduced a price increase of approximately 10 percent with the aim of positioning the champagne in another (more exclusive) market segment. As a reaction to this price increase, the sales decreased by about 30 percent.

**Inelastic Reaction**
Let us assume that an enterprise increases the price by 10 percent and the demand falls by 5 percent. As a consequence, expenses and turnover will increase. This can be called an *inelastic reaction.* An example of a very inelastic reaction is the petrol or gasoline price and the associated demand (consumption) for petrol. In spite of a particular strong increase in petrol prices, the demanded quantity only falls disproportionately slightly.

Iso-elastic, completely inelastic or completely elastic reactions are also possible in principle, however the above scenarios are the common ones to occur in practice.

In summary, it can be stated that a price increase does not necessarily increase the turnover of an enterprise. This only applies when the demand reaction is inelastic. These examples can also be used for the reverse case of a price reduction. Then the price elasticity must also be evaluated in reverse. The aim of a price reduction is usually to increase the turnover, yet this strategy will only be successful in the case of an elastic demand reaction [for the concept of elasticity in general see explanations in Hardes/Mertes/Schmitz (1998); Doyle (1998)].

**Practical Relevance for Young Enterprises**
The knowledge regarding the various types of elasticity, in particular price elasticity, helps an enterprise to anticipate possible reactions to price changes. The question whether a price change will have the desired effect, can be more easily assessed. For example, founders in the process of writing their business plan may discuss possible reactions when mapping their turnover and sales plan.

In marketing the **price elasticity** serves to gauge customer behaviour and therefore to develop a *strategic pricing policy.* In contrast to pricing measures related to a point in time or to a limited time period, which serve, for instance, for a short-term sale of seasonal goods or to support a marketing campaign, the knowledge of the overall price elasticity in the market is of strategic significance. Among other things, it is used to establish the threshold price beyond which an increase in the price will reduce the sold quantity to such an extent that the total turnover is lower than before the price increase. Also in the case of the sales of a product or a service remaining below expectations, it is possible to determine whether a price decrease is reasonable from the point of view of the enterprise by estimating the underlying price elasticity of demand. Thus, the price elasticity can be used as indicator in marketing controlling, in particular in order to monitor the robustness of one's own pricing decisions in case of fluctuations in the demand.

Price elasticity is one form of elasticity. Quantity changes of a product can also be caused by other factors, e.g., the prices or price changes of other products as well as the income available to the potential buyers; i.e., *cross price elasticity* and *income elasticity*. The **cross price elasticity** defines the *positive or negative relationship between two products or services.* These products are either *complementary goods* (positive relationship) or *substitute goods* (negative relationship).

**Complementary Goods**

Complementary goods can be defined as *products which increase the benefit of other goods* and are therefore to be seen as complementary to the latter. Some examples are coffee and sugar, toothbrush and toothpaste, laptop and laptop-bag, software and hardware. As an impressive example for a wide range of complementary goods, the auxiliary products surrounding the extremely successful music-player *iPod* from *Apple* can be listed. On the one hand, *Apple* themselves offer a great number of complementary goods around *iPod*. Within this context, protective bags, remote controls, specific connecting cables and high-quality headphones can be quoted as complementary goods, which can be used directly with the *iPod* and are designed to increase the benefit to the consumer. Embedded in a holistic enterprise strategy, the *iTunes* music store, in which music and videos can be bought, may also be seen as a complementary product. After purchase, this music can be transferred to the *iPod* for listening, or, depending on the model, purchased music videos can also be watched on the *iPod*. However, it is not only *Apple* that offers complementary goods for the *iPod*. There is a broad pallet with a wide range of different complementary goods for the *iPod* from other suppliers. These include, for example, bags, protective covers, loudspeaker systems, arm sleeves or systems for the connection to the car radio, which are offered directly by individual car manufacturers such as *BMW.* Strategically, it can therefore be useful for a young enterprise to offer its own complementary goods built up on a base product such as the *iPod* in order to increase customer benefits. In addition, a further strategy might consist in offering complementary goods for already existing, successful products.

**Substitute Goods**

Substitution goods can be defined as *products which reduce or substitute the benefit of other goods*. Substitutes are a threat because they may reduce the demand for one's own products or the may even completely replace them. Examples are coffee and tea, CD and DVD, DVD and Blue-ray, portable CD-player and digital music-players. The introduction of the *iPod* from *Apple* has, for instance, contributed to a boom in portable music-players, especially in the segment of high-quality products. The usefulness of the *iPod* lies in its simple, elegant design, its easy operability and the communication of a sense of lifestyle. *iPods* are to be seen as substitute goods for products based on older technologies, as, for example, cassette-based music equipment (e.g., the old *Sony Walkman*) or portable CD-players. *iPods* can also be interpreted as substitute goods to other innovative music players, the practicability of which are often not as highly assessed by customers as that of the *iPod*. *iPods* can also be seen as substitute goods for permanently located CD-players and other music equipment. The example of the *iPod* shows that, mainly due to technological progress (in particular disruptive technologies), new, innovative products are repeatedly created which substitute the traditional products or push them out of the market (either partly or completely).

**Pricing Strategies**

Different factors, such as, for instance, the market situation (buyer's market or supplier's market), competition situation (polypolistic, olipolystic or monopolistic market), the current situation in supply and demand (supply or demand surplus), the novelty degree of the product as well as the above-mentioned influences of the elasticity of the demand for a product, have an effect on pricing. For these reasons, the price calculation, in association with the assessment of corresponding sales quantities to be expected, represents one of the greatest problems for young enterprises. In simplified terms, four basic types of pricing strategies, in particular to establish initial prices, can be distinguished:

- High-price strategy
- Price skimming strategy
- Low-price strategy
- Penetration pricing strategy

The application of a **high-price strategy** is typically recommended in the case of an *innovative product with corresponding competition advantages* as well as perhaps also *in the case of technological advantages over the competitors* [Doyle (1998); Kotler/Keller (2006)]. During the introduction of the product, the price is set at a high level. The aim is, for instance, an aspired quality leadership. A (high) sales price may also be part of a branding strategy contributing to the premium positioning of the product. In the latter case, high quality is often presumed, when prices are high. Branded products often have a function of quality presumption. When applying an exclusive high-price strategy, the price is not decreased during the product's life-cycle. An enterprise which follows a consistent high-price strategy is the Danish electronics manufacturer of entertainment equipment *Bang & Olufsen* (B&O). In practice, no noticeable price reduction due to a continuously growing competition pressure can be observed, for *Bang &*

*Olufsen* see themselves rather as premium suppliers. Among their customers, a higher readiness to pay is generated for an exclusive, timeless design. Many *B&O* products are designed in a way to allow further technological adaptations and updating, even after the purchase. Often, the design of the product once introduced by *B&O* will remain the same in its basic features, but is continuously adapted to current and future trends of technology. This includes, for instance, the mobile phones (wireless) of the *BeoCom* range.

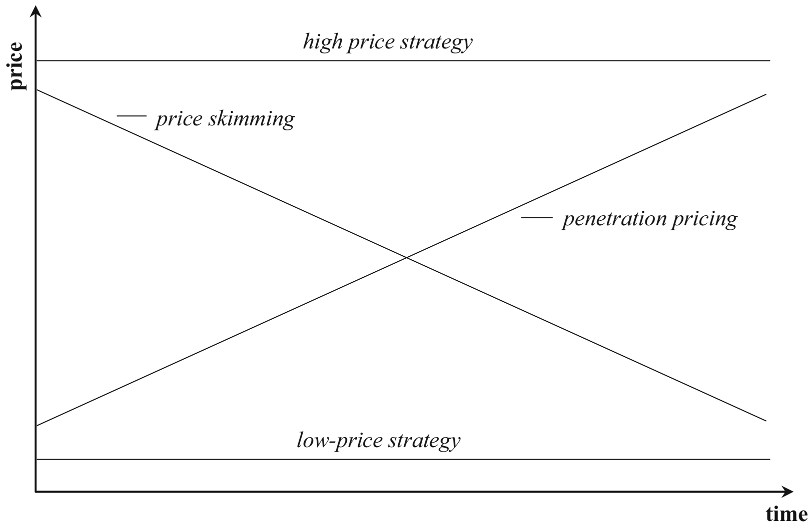
**Price skimming** can be seen as a variation of the high-price strategy. Starting with a high initial price, the price is reduced from a certain point of time onwards, with such a moment in time possibly being the entry of new competitors into the market. This is usually associated with a decrease in the time or technology edge over competitors. In the course of time, competition pressure leads to a reduction in the price. Therefore, the advantage in technology and time should be utilized to *"absorb"* the market and to recover initial costs before competitors step in the market. The introduction of the product at a high price level, anticipating and taking into account the experience curve, can be seen as a variation of this approach (experience-curve pricing). The product is introduced at a high price, in order to skim off the market. In the course of time, experience in the process of the production of goods and services is collected and improvements are generated which, under unchanged conditions, lead to a complementary additional decrease of costs. In particular, process-innovations and improvements in the employed production-technology may facilitate such decreases in production costs. Thus, the price can be reduced in the course of time. Such price strategies are applied, for instance, in the areas of computer hardware and entertainment electronics. Examples in computer technology are the introduction of a new line of processors by the enterprises *Intel* and *AMD* as well as the graphic chips of the two leading enterprises *NVIDIA* and *AMD (former ATI).*

The **low-price strategy** aims at the introduction of *products at a low price* and at keeping prices continuously at this low level. The aim is often an aspired cost leadership. A strategy of cost superiority is mostly to be recommended in *markets with a high competition density* and the identical or similar products. The realization of such a strategy can represent a challenge for young enterprises, as the financial resource base is often insufficient. There are, however, practical examples of enterprises which have entered saturated markets successfully as newcomers and grown in them using a low-price strategy. Well-known enterprises in this context are the discount grocery chains *Aldi* and *Lidl*, as well as *ING, EasyJet* or *Ryanair*.

A variation of the low-price strategy is **penetration pricing**. With this strategy, the product is to be quickly introduced and distributed through low prices. A quick penetration of the market at a low to almost non-existing profit margin is aspired to. One objective is to achieve a high market share within a short time. The competitors are to be partly or completely pushed out of the market, so as to then be in a position to increase prices later on. This strategy is very cost-intensive, as margins are low. At the same time penetration pricing requires substantial promotion and advertising efforts to enter the market and gain market share rapidly; i.e., this approach requires a strong financial resource base since advertising costs will be high while cash flows from sales tend to be modest in the beginning. Too, often a low-price strategy is maintained over time, for the prices cannot be increased as the customers have become used to the low prices. Any increase will then lead to a (massive) loss of customers, in particular in cases when of elastic demand for a product.

Illustration 4-9 shows the four idealized pricing strategies discussed above:

***Illustration 4-9:*** *Idealized pricing strategies*




Additional simple forms of **price formation** are *competition pricing* as well as *cost pricing.* In **competition pricing,** prices of competition products and their price elasticity can at least be used as starting point for the subsequent internal pricing. However, at the same time it is necessary to take into account one's own product positioning, the performance range and scope of the product, the target group and their needs, distribution channels and communication tools, which can influence the price. The **cost pricing (or mark-up pricing) method** is carried out mainly on the basis of the cost price or manufacturing costs of a product within the enterprise (plus a mark up charged to customers). Depending on the chosen costing method and degree of detail, managerial accounting data can be prepared for developing a sound pricing strategy. In general, all types of costs within the enterprise should be taken into account, as all costs ultimately arise for a product or have to be attributed to it. Within the framework of **psychological pricing**, *even and odd price amounts* are significant. *Odd price amounts* make a *product appear psychologically more favourable*, e.g., 399 Euro instead of 400 Euro or 2.99 Euro instead of 3 Euro. The odd numbers, in particular with smaller amounts, suggest a favourable offer. In **distribution-oriented pricing**, the formation of the price can be carried out against the background of the complete distribution chain. In particular, in the case of a multi-step indirect sale, the associated margins of the individual intermediaries are to be taken into account, as these also have an influence on the price for the end-customer.

Using a simplified method, the costs of the production, other enterprise costs (e.g., administration and distribution costs) as well as a profit margin, a possible discount and any rebate, are added in this pricing to arrive at a nominal sales price. A simplified example is shown in Table 4-1.

***Table 4-1:*** *Example of a price calculation*

| Calculation method | Mark-up in % | Calculated value |
|---|---|---|
| **Cost price/production costs** | | |
| + other cost types<br>(e.g., distribution, administration) | | |
| **= cost price** | | |
| + profit to be made | | |
| **= cash sales price** | | |
| + discount | | |
| **= target sales price (net)** | | |
| + rebate<br>(+ trade margin) | | |
| = listed sales price | | |

The above calculation is, in principle, applicable to all types of enterprises, be it trade, production or service enterprises. It is important in this context, that the profit to be made, any possible discount or rebates, are included directly into the calculation of the price. The inclusion of a profit mark-up based on the cost price is easy to understand, as it forms the basis for generating profit.

### 4.2.5.3 Communication Policy

The communication policy or strategy deals with the central question through which measures, or tools, the benefits of a product or an enterprise can be communicated to the customer. The currently prevailing buyer market and the intense global competition in many industries (partly because of the introduction of the internet) have led to a continuously increasing importance of issues relating to communication policy. The tools of communication are designed to win the attention and willingness to buy of the target customers and to create a relationship of trust between the enterprise and the customer. Put plainly, the **communication policy** comprises *tools and measures for market formation and customer acquisition* as well as *for influencing the overall market as well as the mind set of customers*. Sometimes the core elements of the third of the four Ps are called promotional mix, including advertising, personal selling and public relations, however, there may also be additional tools. The following communication tools are usually distinguished in marketing literature and practice:

- Advertising
- Personal sales
- Sales promotion
- Sponsoring
- Trade-fairs
- Public relations

On the basis of *advertising media* and corresponding *advertising material,* different types of **advertising** tools can be created. **Advertising media** or advertising vehicles serve to communicate advertising messages, such as, for instance, unique propositions and benefits of a product or services to customers. Advertising messages only show their effectiveness when they are transported via *media suitable for the relevant target groups.* Within an advertising medium, different types of **advertising material** can be assigned to specific products or messages.

Examples for **advertising media and associated advertising material** are listed in Table 4-2. [Based on and extending Löffler (2004); Becker (2006); Doyle (1998); Blythe (2005)]

*Table 4-2: Advertising media and types of advertising material compared*

| Advertising media | Associated types of advertising material |
|---|---|
| *Print media* | |
| **Newspapers** | – Advertisements, inserts |
| **Magazines** | – Advertisements, inserts |
| **Special advertising forms within newspapers and magazines** | – Supplements, inserts, glued-in free samples<br>– Enclosed product samples, give-aways |
| **Poster sites** | – Posters, city light-posters |
| *Electronic media* | |
| **Television** | – Television spot, split-screen advertising,<br>– TV left split, road block |
| **Radio** | – Radio spot, short teaser |
| **Cinema** | – Cinema advertising film |
| **Internet** | – Banner advertising, AdWords, e-mail<br>– Interstitials, prestitials, flash-games<br>– Social networking sites (facebook, xing, twitter etc.) |
| **Mobile phone** | – SMS, MMS etc. |
| *Personalized special forms* | |
| **Direct marketing** | – Mailings, telephone marketing<br>– Interactive media<br>– Direct mailing, product samples<br>– Mail-order catalogues |
| *Transport media* | |
| **Rapid transit, underground, passenger cars, trucks, buses, airships, airplanes** | – Posters, banners<br>– Light-box transparencies<br>– Full-body external advertising |
| *Miscellaneous* | |
| **Persons (also sponsoring)** | – Clothing and accessories |

The individual groups of advertising media and advertising material comprise many and diverse **means of design**, such as *motto, slogan, colour and type face,* as well as a specifically developed *layout, image, logo* and a specific *tone quality of advertising texts and messages.* The means of design are mainly based on concepts of *light and colour* as well as *scent and sound.* In addition, *haptic concepts* are also employed (concepts of sensual perception via mechanical stimuli or touch) by using, for instance, specially structured types of material. Development and utilization of these individual means of design can be associated with high costs, depending on the degree of extravagance.

Advertising is generally a cost-intensive marketing instrument. For young enterprises with a limited budget it may prove to be preferable to employ **alternative marketing tools** within their communication policy. Thus, *personal sales, sales promotion, exhibiting at trade-fairs* as well as the area of *public relations* can be considered. [For additional instruments for new and small business with limited marketing budgets readers may consult the guerrilla marketing tactics in Levinson (1998).]

**Personal sale** instruments offer to young enterprises the possibility of informing potential customers clearly and to the point, about the product and to sell the products directly without any intermediaries. Information is passed on directly to potential customers and clients without any losses at various interfaces of communication. The questions of the customers can thus be answered individually and intensively, and the customer can thus be motivated to buy. This measure is however very time- and cost-consuming and can on occasion completely absorb the capacities of the founders. However, there are industry sectors where personal selling is the rule, e.g., in industrial business-to-business segments where expensive capital goods are offered.

Another marketing tool is sales promotion. The concept of **sales promotion** entails measures which are intended to contribute to an increase in the sales results. Target groups of the sales promotion are mainly customers, but also *the trade* (wholesale or retail) or the company's own *distribution personnel*. The measures of the **sales promotion** can be targeted directly at the **customer** *(consumer promotion).* In this case, the product is promoted to the customer at different localities, mostly for a limited time, and is adapted to the specific target groups. The objective is an increase in the demand from the end-customer. Closely related to consumer promotion, there are instruments of sales promotion specifically tailored to support of the **retailers** *(trade promotion)* through the employment of various devices, such as, for instance, prize competitions, samples and tasting in retail stores, special packages of the product, or packets with additional benefits (e.g., the addition of toys or other gimmicks). Classical measures of sales promotion are sometimes carried out across branches of the retail business. Usually samples of the product are distributed for tasting to the customers, such as drinks in the drinks market. The young enterprise makes product information or displays about the product available to retailers and traders. In addition, leads for a better shop layout or product placement can be given. Campaigns for selling off products can also be started. Such measures are, however, capital-intensive as regards achieving a broad effect and wide coverage. Measures of communication policy can also refer to **em-**

**ployees of the field service** and the **sales force** via orientation courses, further training as well as sales-supporting material such as brochures or flyers. Through bonuses, employees of the field service are expected to encourage the sales personnel to a more intensive working of the market or customers. In other words, these tools are targeted at the distribution channels used by the enterprise. To carry out these measures would probably also be difficult for young enterprises due to their usually limited financial resources. However, a system of performance-related pay (instead of fixed pay) of key sales employees may be implemented by young enterprises so as to connect personnel costs more directly to market success and cash-flows generated from turnover.

**Sponsoring** is the *support of an individual person, a group, an institution or an event* through the supply of *financial* or *material resources* as well as provision of *services*. Sponsoring is characterized by a performance fulfilment of the sponsor as well as of the sponsored. *Quid pro quo, (service for service in return)* is the principle which distinguishes sponsoring from a donation. Besides the direct publicity effect and distribution of the sponsor's logo, the sponsor often hopes that the existing empathy for the sponsored will be transferred onto the sponsor himself, creating a positive image effect. Generally, the advantages of sponsoring lie in addressing the target group in a non-commercial situation, such as, for instance, sports events. In this way target groups can also be addressed which cannot be reached with traditional communication measures. This is especially relevant for young enterprises, as a sponsoring measure may in some cases be financially more advantageous than a direct advertising measure. In addition, television, popular newspapers or daily papers can be used as multipliers for sponsoring messages without requiring directly the purchasing of advertising space. Thus, it is possible to achieve an increase in the level of brand awareness of the enterprise through sponsoring.

An example for a targeted and publicity-effective sponsoring is *Red Bull*. This enterprise sponsors individual sportsmen and women, sports teams (for example, in the formula 1) or events such as, for instance, the *Red Bull* Flying Days, the *Red Bull* Air Race or championships in "paper airplane construction" and long-range throwing.

**Exhibitions at trade-fairs** can be a suitable tool of communication policy for young enterprises because of the often more homogeneous group of visitors of a fair (e.g., as compared to the readers of a newspaper). Thus, young enterprises can present their products directly oriented at target groups. The exhibition at a trade-fair must be prepared and followed up using specific marketing measures. It may be advisable to inform potential customers in advance about one's participation in a trade-fair or to invite them directly. Trade-fairs offer the opportunity of introducing products and perhaps even negotiating concrete contracts. Beyond wining new customers, special interest trade fairs also offer opportunities for learning about the needs and wants of the target group, novel products and design trends as well as new competitors. Integrating exhibitions at trade fairs in one's marketing tool-box may therefore be valuable for young enterprises in many ways.

Finally, the area of public relations can be of fundamental importance for young enterprises. Directed at the business environment, **public relations** instruments try to create a positive attitude of external stakeholders towards the enterprise itself (*external public relations*). The target groups of public relations are all persons (stakeholders) who can have an influence on the enterprise. As compared to advertising spots, which are placed in television or radio at high prices, the costs for measures of public relations are normally significantly lower. For young enterprises, which want to build up a positive image and gain the trust of their customers and other vital stakeholders (e.g., investors, technology partners), the instrument of public relations can be recommended, if only due to the aspect of cost. The work with representatives of the press requires, however, a certain experience and professionalism and should be carried out by those who are responsible for marketing in the young enterprise with competence and thorough preparation. Systematically, the area of external relations should be distinguished from *internal public relatio*ns. Within internal public relations, employees are, for instance, informed and motivated with regard to the business situation of the enterprise, its future strategy as well as specific activities planned by the management. Young enterprises can build up a positive and possibly also long-term relationship with their employees. In terms of marketing, employees too can function as advertising multipliers and serve as a "marketing medium", e.g., via word of mouth.

From the point of view of young enterprises, there are two essential **dimensions of public relations**. On the one side, the enterprise should aspire to *generate a positive image with a publicity effect.* This may support any advertising messages and have a positive influence on the buying decisions of (potential) customers. Positive *image effects* will thus form the *basis for further activities of the overall communication policy.* On the other side, the enterprise should try *product placements via public relations measures in the editorial and not advertising sections of different media,* such as newspapers and magazines, but also in radio and television. In this way, the tool of public relations is employed as a substitute for other forms of advertising measures. Successful placements may work easier for innovative products with clear and unique customer benefits, which can be communicated in a simple way. For unusual product ideas, which represent an enrichment of the content of the editorial part of a medium, there is a relatively high chance of a successful placement. In this context too, the planning of public relations activities is important, as these should be developed purposefully and, as far as possible, be target-group-oriented. The generation of a **staged plan** could help to create a corresponding advertising pressure. This means formulating a strategy which determines how, when and in which sequence, public relations measures are to be produced in the different advertising media. This should happen within the context of an **integrated communication policy,** i.e., a *coordination of all communication measures.*

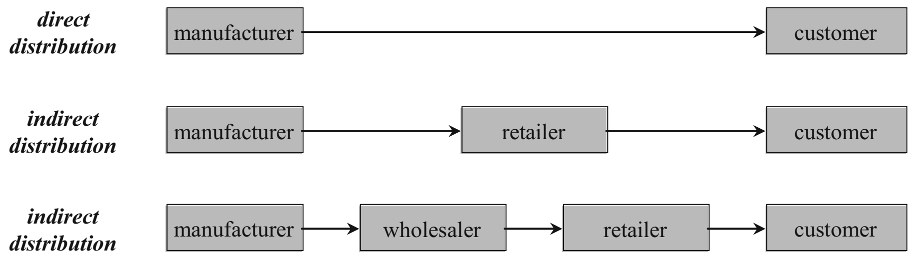
Good networking contacts to media representatives in various fields can be used with benefit in the application of **public relations instruments**. A direct contact to representatives via press reports about the enterprise and its product and service offers should be prepared and established. Further tools would be frequent press conferences, the use of attractive, target-group oriented, business reports, brochures, flyers and an in-house magazine. In addition, the organization of plant visits, factory tours or open door days are relevant. Procedure and process innovations can also be seen as an occasion for public relations measures, e.g., if these represent an improvement of the ecological production conditions. Other opportunities may be the opening of new stores or production sites, the negotiation of important contracts or other milestones in the development of the enterprise.

#### 4.2.5.4 Distribution Policy

Distribution policy addresses the following central question: Through which channels will the products and services of the enterprise reach the customer? There are only few studies on the choice of distribution channels by new and young enterprises, mostly in the context of internationalization [e.g., Rasheed (2005) or Ojala/Tyrvaeinen (2006)]. Principally, various factors may affect the choice of distribution channels by entrepreneurs, in particular market-, enterprise- and product-related characteristics. A typical challenge for entrepreneurs to enter new markets (be it domestically or internationally) is the corresponding uncertainty, e.g., in terms of initially low customer acceptance [cf. Gronhaug/Haugland (2005)]. In addition, distribution channels have changed considerably. In the past, distribution only entailed traditional "brick and mortar" channels. However, over the last decade the internet has become an important additional channel. Today, the concept of distribution policy comprises all market activities of the enterprise which refer to the physical or virtual transport of a product or a service from the place of production to the place of consumption or reception of goods and services. This comprises the *selection and the arrangement of the distribution channels* and possible inclusion of wholesalers and retailers in the delivery chain. The distribution channel between the enterprise and the customer can be arranged as a *direct distribution channel* (direct connection between manufacturer and customer or via the internet) or as an *indirect distribution channel* (indirect connection between manufacturer via wholesaler or retailer to the customer).

Illustration 4-10 defines in simple terms possible types of distribution channels.

*Illustration 4-10: Types of distribution channels for goods*




The choice of a suitable distribution policy depends on different factors. The distribution can occur via direct or indirect distribution paths, depending on the product or service. For young enterprises the choice and design of the distribution channel depends on their anticipated marketability, their acceptance by the customers and their prospective profitability as well as on the interests of wholesalers and retailers in the case of an **indirect distribution.**

The distribution capacities, storage and exhibition space of wholesalers and retailers are usually limited, so that the new products of a young enterprise may have to compete with a large number of complementary or substitutive products of young and established enterprises, depending on the age and structure of the market. In this context, the profit margins of wholesalers and retailers, as well as the anticipated turnover rate of the product are decisive. Both variables together determine target sales volumes and revenues as a (simple) turnover function: price times quantity during a definite observation period. For young enterprises, agreed terms of payment for the wholesalers and retailers are important in this context, as a young enterprise sometimes has to grant extended credit terms to ensure that its own products will be included in the retailer's range of products on the shelf. In grocery retailing, for example, payment respites of possibly up two or three months must be granted to large retailers. In combination with the anticipated turnover rate and the associated additional distribution and delivery costs of the young enterprise, a high degree of liquidity must be maintained. It may, for instance, happen that products are sold several times by the trader, until the first delivery of goods is settled. The value added of the retailer is on the one hand due to the profit margin of the product itself. On the other hand, the retailer generates a long payment respite and thus a supplier credit.

With this in mind, it is recommended for the distribution policy of young enterprises to strive to generate early cash inflows to be offset against later expenses. In this way, a high payment differential between purchase and sale prices may be achieved.

As regards the **direct distribution** of products, the developments in information and communication technologies of the last few decades have created highly significant opportunities for realizing direct distribution strategies, which can benefit young enterprises in particular. As successful pioneers in this context, the enterprises *Dell* and *Amazon* can be cited. The internet allows a young enterprise to introduce a direct distribution via an online-shop or an electronic market place. Although at the beginning online-shop systems were expensive due to the low availability, today the cost factor can be more or less neglected. Thanks to the open-source-movement, there are even systems free of charge, which can be integrated through the combination of different modules from a content-management through a document management to a shop system. Free or low-price content-management systems are, for example, *Typo 3, Mambo/Joomla!* or *Word Press* As a comprehensive open-source e-commerce system (shop system) *osCommerce* can be named as examples.

In part, it is no longer necessary to use one's own software and hardware. Commercial trade platforms, such as, for example, *eBay* or to some extent *Amazon*, offer the opportunity of using their platform to young enterprises for making their own product range available. The trade platforms can be used both as sole distribution tools and also in the form of an integrated, own direct and indirect marketing strategy. This can be seen as strategies of cooperation, which, in principle, allow anybody or any institution to take on the function of a trading business and enter into contact with customers.

In addition to a direct marketing via the internet, products can also be offered via the *television* in special shop-transmissions or shop-stations, such as, for instance, in the *QVC, HSE* or the *RTL shop.* But also *traditional forms of direct distribution* as, for example, *Tupperware, Ha-Ra* or *Avon* may be used. In these cases, often so-called "product parties" (e.g., tupperware parties see www.tupperware.com) are organized in the home environment, where the products can be presented, tested and directly bought or ordered. Founders should be aware that direct distribution channels have very specific characteristics and conditions. It is often difficult for new products or services to judge beforehand whether one of these direct channels will work well in terms of reaching end customers. At the same time, such distribution channels may offer effective paths to the customer. In summation, it is advisable to discuss decision on distribution policy intensively within the founder team, based on prior market research and possible testing of alternatives.

## 4.2.6 Media Mix Planning

**Media planning** facilitates a target-oriented combination and *mix of individual advertising media and types of advertising material for a specific target group* and thus the *allocation and distribution of the advertising budget across the individual advertising media and types of material.* For a purposeful application of media planning, relevant data must be available, for instance, consumption behaviour and frequency of the target group with regard to the individual advertising media [Doyle (1998)].

As a rule, professional **media agencies** develop software-supported customized media plans. The software used can then access target group profiles and consumption times of the individual advertising media and evaluate them in an integrated way. Thus the generation of a detailed **media mix** is possible, which is tailored to the target group in question. This opportunity is usually not available to young enterprises, as the employment of a professional agency is cost-intensive and cannot be considered within a normally small advertising budget. As a rule, media planning agencies obtain a percentage share of the total advertising budget for their planning services. Small advertising budgets are not interesting to agencies because the profit margin is too low.

Even so, in some cases, a media mix suggests itself to young enterprises too. The advertising media have different reaches, and even with a small budget, the general aim is to achieve an as high as possible coverage and effective structure of the advertising measures. For this reason, some **indicators of media planning** are briefly discussed, such as *reach* (media coverage), *gross reach* or *net reach* as well as *internal and external overlapping* and *affinity,* so that, within a rough framework, the most important indicators are known and the advertising data, e.g., in newspaper adverts, can be correctly interpreted.

The overall reach shall serve as the starting point for the media planning. The reach indicates the consumption percentage share of people, who use a medium (television, radio, newspaper etc.) during an advertising campaign. The reach always refers to the advertising medium or advertising vehicle and not to the advertising material, as it cannot be determined whether a printed advertisement in a magazine, for instance, has really been looked at. For example, the reach for print media is defined as reader per issue or reader per number [Löffler (2004)].

The **gross reach** is defined as the sum of all reaches of a media plan over all media, from which no overlaps are subtracted. The gross reach therefore refers to the *numeric frequency of contacts.* It can be derived by multiplying the reach of a medium with the associated occupation frequency. It is obtained by the share of the people reached, multiplied with the relevant average contacts. In this context, one often talks of the so-called **gross rating point (GRP).** The GRP refers to the *gross reach in percent.* The GRP is a rating measure for the advertising pressure of a media plan, as it shows how many average contacts are achieved for 100 target persons. Internal and external overlaps are not taken into account. The **internal overlap** refers to the contact of the same advertising material in several issues of the same advertising medium. **External overlaps** describe contacts with the same advertising material in different media. The GRP serves to compare different media plans for the same target groups. Thus, the calculation of the GRP allows a comparison of different media plans. To determine the GRP, the gross reaches of all media of a plan are formed, and the products are added together. As the gross reach is always defined only for a special target group, only the same target group products should be added up. Adding up different target groups is not possible [Löffler (2004)]. **Net reach**, conversely, describes the consumption percentage of the target group which is reached at least once in a media plan via the media. Overlaps and multiple contacts are subtracted.

In addition to the individual reaches, the determination of suitable advertising media via the affinity of the target group to the advertising medium is to be considered. The **affinity** reflects the over- or under-representation of the target group in proportion to the total number of users of a medium.

This short introduction to media mix planning will be concluded with the *first and the second "law of accumulation".* According to the **first law of accumulation** in the context of media planning, the higher the degree of overlapping is in the advertising media, the lower the reach, but the higher the advertising pressure. The **second accumulation law** states that the lower the degree of overlapping, the higher the reach, but the lower the advertising pressure.

The individual reaches should not be regarded as the measure for the ultimate success of an advertising campaign. There are further factors to be taken into account, such as the design of a medium plan as a whole, as well as the design of the advertising vehicles using target-group-specific types of creative materials. The success of advertising messages depends, in the individual case, also on the consumption intensity and the generation of attention by the medium in the target group, as well as possible interfering events during the planning period, which cannot be calculated. [Other factors may include the overall audience quality of a medium or the placement of the advertisement in the medium; Doyle (1998).]

Media planning is a vast field, which can only be presented in an overview within our context. However, media planning can be exploited systematically by young enterprises, in order to achieve an advertising effect of great intensity within the target group of customers. It may be assumed that not all forms of media planning are employed by a young enterprise, as the necessary know-how or specific data regarding the media market are often lacking. It, however, also applies that a young enterprise can look for external support in this area. Whether a media-planning agency can be given the commission, will depend on the total budget of the planned marketing campaign of the young enterprise. Cooperation with universities may be another option. In this way, a young enterprise can gain an impression of the field of action, the strengths and weaknesses, as well as the challenges related to media planning. There is a very good theoretical and practice-oriented literature available for the topic of media planning [see, for example, Sissors/Baron (2002) or, in German, Löffler (2004)].

Within communication policy, many advertising media are not feasible for young enterprises, as they are too cost-intensive. Television spots, for example, but also magazine ads or large advertisements in daily national newspapers come to mind. One should be aware that a high reach or critical advertising pressure must be built up in order to reach the target group at all. At the same time, it should be planned to what extent, during which period of time and with what geographical coverage the target group shall be addressed. With the resources and the given budget available, a young enterprise could try to carry out a media mix in order to realize at least a critical threshold reach for its advertising measures.

# 4.3 Comprehension Test and Recommended Literature

## Comprehension Test

- Explain how far marketing can have an influence on the success of a young enterprise. (4.1)
- Briefly explain the different orientations of marketing. (4.1)
- Define the concept of marketing planning and explain the different phases. (4.2)
- What are the components of a market and competition analysis? (4.2.1.2)
- Differentiate the concepts of market potential, market volume and market share using an example. (4.2.1.2)
- On the basis of which criteria can market segmentation and positioning be carried out? (4.2.1.2)
- Name potential tools of a competition analysis. (4.2.1.2)
- Discuss economic and market-psychological marketing targets. (4.2.2)
- Name and discuss the three generic strategy directions (competitive strategies) when entering a market according to Porter. (4.2.3.1)
- Explain the concepts of the red and blue oceans. (4.2.3.1)
- Distinguish the pioneer and follower strategies within the context of the market entry strategies, and discuss the associated advantages and disadvantages for young enterprises. (4.2.3.2)
- Describe in detail the individual areas of the classical 4P-marketing-mix and their relevance for young enterprises. (4.2.5)
- Discuss the concept of price elasticity and underline its importance for young enterprises. (4.2.5.2)
- Characterize in detail significant tools of communication policy, in particular for new enterprises with a limited financial resource base. (4.2.5.3)
- Describe potential distribution channels within the distribution policy of young enterprises. (4.2.5.4)
- Discuss the concept of media mix planning and present individual indicators which may be used to develop a media mix. (4.2.6)

## Recommended Literature

### Marketing – standard works

*Brassington, F./Pettitt, S.* (2006): Principles of marketing, 4th edition, Harlow 2006.

*ESOMAR* (2007): Market research handbook, 5th edition, Chichester 2007.

*Kotler, P./Keller, K. L.* (2006): Marketing Management, 12th edition, Upper Saddle River 2006.

*Malhotra, N. K./Birks, D. F.* (2007): Marketing research: an applied approach, 5th edition, Englewood Cliffs et al. 2007.

### Market research and media planning

*Kelley, L. D./Jugenheimer, D. W.* (2008): Advertising media planning: a brand management approach, 2nd edition, Armonk 2008.

*Sissors, J. Z./Baron, R.* (2002): Advertising media planning, 6th edition, New York 2002.

*Surmanek, J.* (2004): Advertising media A to Z: the definitive resource for media planning, buying, and research, New York 2004.

### Entrepreneurship and marketing:

*Bjerke, B./Hultman, C.M.* (2004): Entrepreneurial marketing: the growth of small firms in the new economic era, Cheltenham et al. 2004.

*Hills, G. E./LaForge, R. W.* (1992): Research at the marketing interface to advance entrepreneurship theory, in: Entrepreneurship Theory and Practice, vol. 16, no. 3, 1992, pp. 33–60.

*Lodish, L. M. et al.* (2001): Entrepreneurial marketing: lessons from Wharton's pioneering MBA course, New York et al. 2001.

*Morris, M. H. et al.* (2002): Entrepreneurial marketing: a construct of integrating emerging entrepreneurship and marketing perspectives, in: Journal of Marketing Theory & Practice, vol. 10, no. 4, 2002, pp. 1–19.

*Smilor, R. W.* (1989): Customer-driven marketing lessons from entrepreneurial technology companies, Lexington et al. 1989.

# 5 Organization and Personnel

Specific questions of organization and personnel planning and management are not relevant for all newly founded enterprises. However, for those start-ups aiming at growth, organizational and personnel aspects are of central importance within the context of a target-oriented and systematic growth management. Generally speaking, for all emerging enterprises, initial organizing activities seem to be critical to their survival [Brush et al. (2008)].

In the beginning of the process of organizational emergence, the human capital of the founder (skills, network contacts etc.) plays a vital role in terms of new venture survival and performance [Cooper et al. (1998)]. However, as the business grows, the acquisition and effective integration of additional employee talent will become paramount. In terms of organizing operations the roles of the founders are often still manageable and the division of tasks functions informally in the start-up phase; however, uncertainties with regard to competences and responsibilities can develop in the course of time and with increasing growth of the enterprise. In this context, the early creation of organization structures and a clear assignment of competences and responsibilities are of crucial importance for the economic success of a young enterprise. In short, the art of enterprise management lies in avoiding both extremes of "over- and under-organization". Over-organization holds the risk of too detailed formal regulations, as increasing bureaucracy may leave little freedom for the individual, while under-organization brings the risk that inefficiencies through work duplication or tasks not carried out at all are caused by a lack of regulations [See Ebben/Johnson (2005) for this classic potential trade-off between organizational efficiency and flexibility in the entrepreneurship context].

Especially in dynamically growing young enterprises, organizational development usually lags behind the development of the enterprise itself. It is a typical *liability of newness* of young enterprises that they *lack established organizational structures and routines* in terms of both external business relationships and internal division of labour [Aldrich (1999)]. In particular, on account of this newness there may be a substantial degree of initial role ambiguity and uncertainty about organizational structures [Sine et al. (2006)], moreover, small and new enterprises often do not have the instruments for adequate human resource development in place within their business [Hill/Stewart (2000)]. Questions of organization often only appear when new employees are introduced, for instance, or if a project organization was not carried out successfully, which releases dissatisfaction on the customer-side. Often, the causes for growing difficulties or even crises base upon the missing or defective organization of structures and processes in a young enterprise.



C. K. Volkmann et al., *Entrepreneurship in a European Perspective*,
DOI 10.1007/978-3-8349-8752-5_5,

Following the start-up phase, enterprises are subjected to a continuous process of transformation as a result of internal and external changes. To be able to cope successfully with a dynamic transformation process and carry out adaptive individual changes, adequate organizational structures and processes are required. [For typical early-stage changes during the start-up process, e.g., adjustments in the aims of the founder, resource reallocations, new "ad hoc" customers, see Baum (2003).] With this in mind, aspects of organization will be discussed in the present chapter which can support young enterprises in designing changes in a structured and purposeful way. In addition, personnel planning and human resource management will be entered into within the context of organization. This is as the acquisition, motivation as well as development and retention of qualified employees are of central importance for young enterprises.

## 5.1 Organizational Planning

### 5.1.1 Organization as a Challenge for Young Enterprises

Organizational structures are subject to a process of change during the life-cycle of an enterprise in many different ways [cf. the different organizational characteristics of enterprises in different life-cycle stages, e.g., as in Stam/Garnsey (2005)]. During the growth process enterprise founders, however, often neglect the designing and developing of the organization as they are concentrated on the operational daily business. [An interesting seminal study of different archetypes of organizational structures as well as organizing modes of entrepreneurs is Gartner et al. (1989). The types identified in the study range from "escaping to something new" in necessity entrepreneurship to "methodical organizing" in opportunity-driven, often innovative entrepreneurial ventures with substantial organizing efforts in all areas of the business.] Then the necessity of organizational measures is often underestimated. Early organizational adaptations of young, growing enterprises to internal and external changes can allow an effective organic development and help to avoid inefficiencies or even crises. In this context, Tidd/Bessant/Pavit (2005) speak of a "routine" of change. [See also Lichtenstein/Candace (2004) who highlight the need for constant, often substantial change especially in innovation-oriented entrepreneurship.]

Organizational relationships can be regarded from different points of view. In our context, organization is understood as the entirety of entrepreneurial regulations, rules, processes and structures which have to be determined and implemented by the leadership of a young enterprise. A general **task of the organization** is then to *ensure the sustained success of entrepreneurial activities.* The following specific tasks can, for instance, be listed:

- Formation, delegation and coordination of tasks

- Management and motivation of employees
- Securing the development capability of the organization

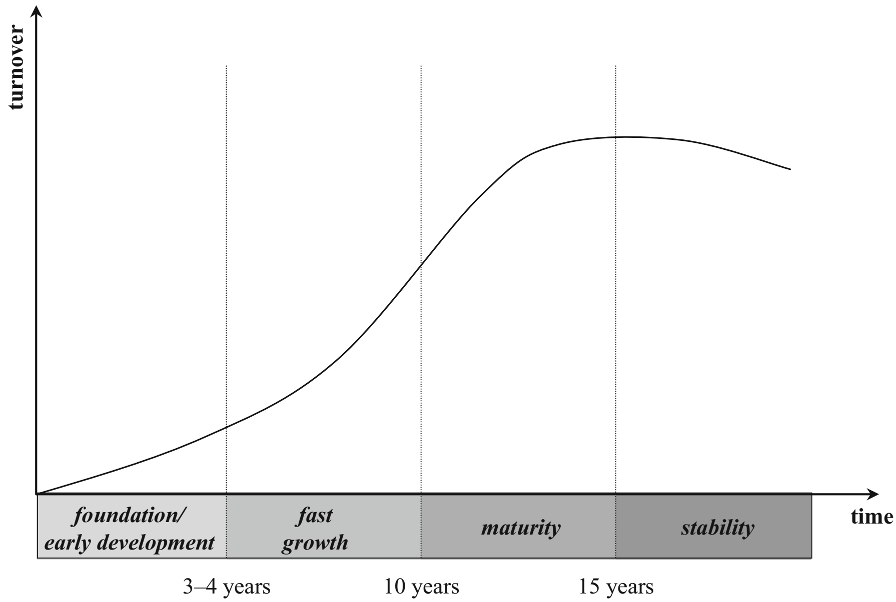
In organization theory, a fundamental distinction is made between **structural** and **process organization**. In the structural organization, it is in essence a question of determining the suitable organizational structure, while in the process organization the order of the operational processes is regulated. In practice, structural and process-oriented organization are closely connected and interrelated.

Start-up enterprises usually do not have complex, formal organizational processes and structures with departments, function or business areas. If young enterprises show organizational structures at all, they are predominantly rather simple in their design. In the early phases of enterprise development, new venture organizations mostly still function informally. However, with increasing growth of a young enterprise, formal organizational structures become necessary. In an action-oriented approach, it is above all the *doing*, the concrete acting, which is the priority of young enterprises. Actions, or activities, usually take place without great formal organizational limitations with, as a rule, direct communication and control due to an informal style of leadership. In the further course of entrepreneurial development, *doing* is substituted by *managing.* More formal organizational structures and communication channels, as well as positions with specific competences, are then created in the enterprise. Moreover, frequently an increasing specialization and distribution of tasks occurs later on, combating the early-stage disadvantages of a low division of labour – which is typical during the beginning of the start-up process [Brüderl/Schüssler (1990)]. With increasing growth, the demands on the founders, but also on the employees, change. Operational tasks are carried out increasingly by employees, with the founders concentrating more on delegation and supervision. The relevant literature contains different opinions with regard to the approximate recommended moment in time at which to build up a second leadership level within the organizational hierarchy. According to empirical investigations, a second leadership level can already become necessary with about 40-50 employees depending on the business sector and specific enterprise characteristics. Timmons/Spinelli (2004) see the critical growth threshold at approximately 75 employees and from approximately 10 million US dollars turnover per year onwards. However, when introducing additional management levels in organizational hierarchies it should be considered that innovation processes, which are typical for high growth enterprises, may benefit from substantial integration of functions and tasks during the course of product development [e.g., Song et al. (1998)].

Consequently, in a further development phase, *managing* is replaced by *managing the managers.* The complexity of the enterprise requires the support of the founders. New leadership levels or management functions are implemented. The founders now lead and manage the executive employees or managers and take on primarily strategic tasks [Timmons (1999); Timmons/Spinelli (2004); Allen (2003)].

Illustration 5-1 shows the critical transitions in the development of an enterprise, following Timmons/Spinelli (2004).

***Illustration 5-1:*** *Critical transitions during enterprise development*




*critical transitions:*

| | | | |
|---|---|---|---|
| **turnover** | \$0–\$5m. | \$5m.–\$15m. | \$15m.–\$25m. and more |
| **employees** | 0 to 20–25 | 25–75 | 75–100 and more |
| **management style** | doing | managing | managing the managers |

Often, the creation of formal organizational structures in young growing enterprises occurs at a rather late point in time when the business development has clearly run ahead of the organizational development. Founders often devote themselves to the subject of organization only when organizational inefficiencies persistently affect the daily business.

## 5.1.2 Informal and Learning Organization

The start-up phase of an enterprise is mostly characterized by an *informal organization.* The founders concentrate first of all on the business activity and the relationships with customers, suppliers and capital providers. As there are no (or only a few) employees in this phase of enterprise development, organizational aspects play no (or only a secondary) role. Communication occurs personally, directly without hierarchical structures. This situation, however, changes with the increasing growth of the young enterprise. With an improving order situation, new people are employed so as to be still in a position to manage all operational tasks and customer orders. However, very often the relationship between employees and founders also changes under these conditions. Due to the growing division of labour in particular, the distance between founders and employees becomes greater from the point of view of geography as well as work content. Simple day-to-day direct communication is then simply no longer possible. In this phase, the first formal organization structures and processes are constituted in many cases and possibly already a second level of leadership. This development usually does not happen without interruptions and frictions and may be associated with conflicts amongst employees themselves and also between the management of the enterprise and the employees.

In the course of the enterprise development, young enterprises are repeatedly confronted with new situations and challenges which need to be met. A learning process can be assumed which may influence the enterprise in a positive or in a negative way. Positive learning processes make it possible to generate structures which introduce a certain order to make it easier for founders and their employees to fulfil their many and diverse tasks. [For an overview of learning modes typical in new enterprises see Minniti/Bygrave (2001) and Lichtenstein (2003).]

**Informal Organization**

Start-up enterprises are often **informal organizations**, influenced by many internal and external factors. Irrespective of whether an enterprise is created as a solo or team start-up, it is typical for the early phase of enterprise development that *leadership structures and standards as well as information and communication channels are informal.* These informal structures can have an effect on the young enterprise in many and different ways. A positive and promoting influence consists, for instance, in motivated, performance-oriented employees. Conversely, passive, unmotivated employees can negatively influence the working atmosphere and the development of the organization.

Under the aspect of organization, it is characteristic in enterprise start-ups that for a limited time the founders and employees can communicate directly. Workflows and processes function informally, frequently by “call or cry”. With increasing size of a young enterprise, it becomes necessary to establish formal structures and processes. An essential task of the founders under these conditions is then to transform informally working employees into formal groups and organization units in the course of enterprise growth. [Typical challenges relating to increased formalization, particularly in the context of additional "managerial processes" in the middle line of management, of growing professional services SMEs are discussed in Quader (2007).]

The **enterprise leadership** functions informally, mostly through the founders. Their leadership style is often cooperative, participative and democratic, especially in team start-ups. Hierarchies do either not exist or they are flat. However, even with informal leadership, standards already exist in young enterprises which, as a rule, are determined decisively by the founders.

**Informal standards** are behaviour expectations or attitudes of members in informal groups, i.e., in our specific case in the relationship between the founders and the employees. Within this meaning, standards determine the behaviour of founders and employees in a young enterprise not only towards each other, but also to the outside world. In spite of the lack of formal structures, early hierarchies can establish themselves in informally managed enterprises, too, not only between the founders and employees, but also in the relationship between the individual employees. For example, group dynamics can shape members attitudes towards an entrepreneurial task and how people relate to it [Shepherd/Kruger (2002)].

**Informal information and communication** can take place in different ways. In young enterprises, an informal, direct and personal communication often occurs between the founders and the employees. Within the context of start-ups, informal communication means that enterprise-relevant information, which is required for fulfilling a task, is passed on to employees without the existence of formal information and communication structures. In addition, informal communication takes place via personal conversations, which are not directly connected with the fulfilment of business tasks. Informal communication, for instance, has the advantage that it occurs very quickly and without a great deal of red tape. It may, however, be a disadvantage that employees receive information which had not been meant for them.

During the growth of a young enterprise more formalized communication channels become necessary. The founders then have the possibility to actively form and institutionalize guidelines for enterprise management and operational standards as well as information and communication processes through an early generation of structures. Therefore, it is advisable for founders to make themselves familiar with typical instruments and concepts of structural and process organization which are relevant to their enterprise at an early stage. In this case, the question of the degree of structuring in the organization is also significant. Although this question cannot be answered clearly in our context, it is basic to ensure that organizational structures which are created are sufficiently stable (e.g., to establish reliability for external partners and to enable efficiency gains through standardization) on one hand but also flexible enough on the other hand (which is a *sine qua non* in the turbulent environment of start-up enterprises). To secure the future of young enterprises, it is essential that they are learning organizations open to changes and innovations.

**Learning Organization**
Within the meaning of organization theory, the concept of **learning organization** or organizational learning describes generally a *process of generation, further-development and securing or storing of knowledge by and in an organization.* A synonym for the concept of learning organization is also the designation of *organizational learning.* In this concept of learning organization, two areas are important for established, as well as for young enterprises. First, a **learning of the organization members** can be assumed within the context of young enterprises, including founders as well as their employees. Secondly, one can speak of a **learning of the organization** itself [cf. Maier (2002)]. Knowledge can be generated in an enterprise in the following areas and made usable for new employees [Bea/Haas (2005); Bea/Göbel (2006)]:

- Enterprise culture (system of fundamental assumptions, norms and value system, emblems)
- Ethical orientation (reflection of conducts, norms, values, formal and informal rules)
- Organization and process structures
- Leadership guidelines, general guidelines, competences
- Processes, routines, lines of action
- Developed innovations and technologies

The business of process-oriented entrepreneurship research is to investigate the relationship between the learning of an organization and the entrepreneurial process. [For approaches to investigating the learning organization or organizational learning within the context of entrepreneurship, see Deakins (1999), Aldrich (1999), Minniti/Bygrave (2001), Harrison/Leitch (2005), or Lueger/Keßler (2006). From their point of view, learning begins with the identification and exploitation of entrepreneurial chances or opportunities.]

However, a **learning process** does *not necessarily imply a positive* development, for it primarily and generally signifies a change within the young enterprise, irrespective of whether the resulting effects are positive or negative. In this aspect, the resistance of employees to changes which have been initiated by enterprise management, for example, can be as much "organizational learning", as can the realization of certain innovative ideas of the founders which lead the young enterprise into insolvency [Lueger/Keßler (2006)]. In the positive sense, a *learning organization* can facilitate an effective moulding of organization development [see also Thommen/Struß (2002)].

Between the learning of the organization members and the learning of the organization itself, interdependent relationships exist. The essential core of a learning organization is the **collection of individual knowledge,** thereby an **organizational knowledge basis** is generated [Maier (2002)]. In the growth process of a young enterprise in particular, a *collecting of individual knowledge, the application of learned, stored and existing knowledge,* as well as a *sustained promotion of learning or the learning process* are required for the **promotion of the learning of the organization** as a whole**.** Within the context of entrepreneurship research, collective learning processes refer to the identification of venture opportunities and associated operational innovation processes. The opportunities, which have been assessed as meaningful by the organization members, are to be transformed in a collective process into the structure of the enterprise [cf. Shepherd/ Krueger (2002) for the collective social cognition of entrepreneurial opportunities]. At the same time, any possible problems, e.g., arising conflicts, are to be taken into account within the context of the change and learning processes.

**Advantages of a learning organization** are the *minimization of the risk of dependencies* through a *decentralization of knowledge* and the *avoidance of information and time losses* caused by interface problems between individual organization units. In particular, a decentralization of knowledge and an empowerment of individuals to accumulate new pieces of knowledge gets the enterprise into a position where it can learn from others (such as technology partners, customers, suppliers etc.) in a local context. [A good example for this is learning in industrial clusters like the Silicon Valley as described by Moore and Davis (2004) in their work on "learning the Silicon Valley way".] Moreover, a *positive innovation climate* can be created by a learning organization within the enterprise which will, for example, facilitate the *generation of product, process or social innovations.* Innovations thus contribute in a positive way to secure the enterprise and to support its growth. In addition, learning organizations may react *faster to changes in the market.*

A potential **disadvantage of a learning organization** consists in the *risk of unplanned knowledge drain and disclosure.* A decentralization of knowledge increases the risk that internal knowledge will be passed on to external third parties, as several employees have access to a specific piece of knowledge. Therefore, it is necessary in this context to weigh the advantages and disadvantages of a decentralization or disclosure of knowledge against each other.

### 5.1.3 Selected Organization Concepts

The business management literature contains many different organizational concepts and models which are available to enterprises as possible design patterns for organizing their activities in practice. In principle many of these organization concepts can also be considered by young enterprises and not only by large, established firms; however, the unique characteristics of the specific business will need to be considered, demanding that traditional concepts may need to be adjusted to fit the individual start-up (e.g., depending on the founder's growth ambitions and the industry it operates in). Because of this heterogeneity in organizing challenges of young enterprises, we here only provide a brief overview of organization concepts pertinent in the general management literature.

In terms of entrepreneurship research, there have only been some efforts to explore the impact of decisions on organizational structures of new ventures on their survival and performance [Ebben/Johnson (2005)]. Mejaard et al. conclude that "organizational structure should be included in studies aimed at a better understanding of the determinants of small business performance" (2005). [Readers interested in empirical studies on types of organizational structures and human resource strategies of new ventures and their performance characteristics are referred to Liao et al. (2003), Sine et al. (2006) as well as Ebben/Johnson (2005).] As regards the choice of a suitable organization form, various aspects must be taken into account, the first question being, "Which organizational units would be expedient for a young enterprise?" This will lead to a second question, that is, "Which relationships or interactions between the different units in the organizational structure exist or should exist?"

**Choosing an Organizational Structure for a Young Enterprise**

Important design parameters of structural organization are, in particular, specialization, division of labour, delegation as well as coordination issues. In general, the volume of tasks carried out within a division of labour as well as the **specialization of labour** according to type (work-role/objects) and degree (high/low specialization) are decisive factors which determine the organization form. As regards the division of labour, the classification of tasks according to location or content is significant. For instance, there is the possibility to organize tasks functionally (e.g., procurement; production; sales across products) or per object (e.g., a product or service line) or project. From the *degree of specialization,* the number of positions to be generated may be derived. A high degree of specialization can lead to increases in efficiency. It could be an advantage to achieve learning effects through repeated activities as well as savings in time and costs due to economies of scale. However, an excessive specialization can also lead to a limitation to both the scope and content of work, i.e., leading to a monotonous activity and thus to the de-motivation of employees. In young enterprises, the type and degree of specialization of labour depend primarily on the qualification and job efficiency of the employees, as well as on the production process of goods and services. When choosing an organizational structure, a low degree of specialization can prove to be advantageous, especially for young enterprises. As the available resources are usually limited, the employees in young enterprises are often offered a comprehensive and diverse spectrum of tasks. In an ideal case, a low degree of specialization leads to an increase in motivation allowing the employees to work better towards a total work result or towards overall enterprise targets. (This presupposes that the enterprise targets have been communicated to them.) Logically, a specialization according to objects (e.g., different product lines) requires that several objects do actually exist. At the same time, the employees must have sufficient technical competence to handle the object.

The **delegation** of authority can be defined as a *transfer of competences (decision rights, control rights, authority to issue instructions) and responsibilities to other* (usually secondary, subordinate) *organization members.* At the same time, delegation means a *decentralization of competences* (decision rights, control rights, authority to issue instructions) to the relevant organizational unit at the relevant decision locality. One can speak of *centralization*, if a *concentration of competences* remains *at the highest management level.* Related to the start-up context, this means that centralization exists if the founders transfer none (or only a few) competences to employees. Decisions are thus made exclusively and centrally by the founders alone. The degree of centralization or decentralization will also influence the structure of the hierarchy, the number of individual management and competence levels. As extreme examples, a *steep hierarchy* on the one hand and a *flat hierarchy* on the other hand can be named. In a steep hierarchy, a low degree of delegation takes place, resulting in a strong centralization. In a flat hierarchy a comprehensive delegation of competences and thereby a decentralization of responsibilities occurs. This means that the founders or the management of the young enterprise transfer essential competencies and responsibilities to their employees so that they are empowered to decide, instruct and control independently. Possible advantages of delegation, for instance, are the *relief of the burden on the shoulders of the founders*, the *higher motivation of employees, faster decisions through employees* or the *generating of potential successors.* Disadvantages in this context are the *generation of problems of control* as well as *problems of coordination with overall enterprise targets.* In essence, the delegation of tasks relating to strategic decision-making in the enterprise also boils down to the traditional question of separating ownership and managerial control (and the opportunism problems relating to this) – this is a particular virulent issue when founders and owner-managers as shareholders in the business make delegation choices to employed management personnel [Alvarez (2005)].

Of crucial importance is also the specific disposition of the employees who fundamentally can be considered for a delegation of tasks and responsibilities. The relevant decision criteria are, for example, qualifications, attitudes, values, norms and the personal aims of the employees. Such determination is sometimes only possible with great difficulty and by use of considerable resources, if at all.

Specialization and delegation require the **coordination** of activities and processes based on division of labour, with coordination and specialization being mutually conditional (the higher the degree of specialization, the higher also the coordination expenses and vice versa). With regard to the structural organization, *external coordination* and the *internal coordination* are important coordinating tools. The **external coordination** within the context of young enterprises means that the coordination is carried out by the founders or the enterprise leadership and not through the employees concerned. Important tools of external coordination are the *coordination through personal instruction* within the framework of super-ordinate and subordinate relationships in the structural organization. In this context, communication systems and lines of authority can be differentiated into *single-chain, multi-chain* or *staff-chain systems (structure* *of authority and responsibility).* Communication or chain systems in this context can be understood as hierarchical structures in which the positions are related to each other under the aspect of authority to issue instructions. In this way, a hierarchical structure of communication is created which, starting from the leadership down to the lowest position in the enterprise, is characterized by a clear route for the authority to issue instructions and for responsibility. Further tools of external coordination are the *coordination through programmes* (i.e., behaviour guidelines and standardizations), as well as the *coordination through plans* (i.e., the understanding of targets and target guidelines). A relevant instrument of **self-coordination** of young enterprises is the *coordination through internal ballot or self-determination* within the meaning of mutual adjustment. (This self-determination can be regarded as the opposite of personal instruction.) In this way, the formation of groups as organization units takes place, with decisions being taken between the individual groups and not hierarchically. Particularly in young enterprises, fast and flexible decisions can thus be taken. This is a typical advantage compared to large, established enterprises which have more resources but are less flexible [Aldrich (1999)].

An essential condition for such "coordination through self-determination" is the capacity and willingness of the employees in question to cooperate. Self-determination can occur formally or informally and often attracts a great deal of attention in young enterprises. Self-coordination can become problematic, however, when the enterprise develops over time into competitive informal groups [Bea/Göbel (2006)], for it can be difficult to introduce formal hierarchical structures later on, which will curtail the previously existing freedom from the perspective of employees [cf. Quader (2007)]. For the founders, therefore, it is a significant challenge to recognize to what extent the employees are capable of acting on their own responsibility.

In practice, young enterprises often prefer a single-chain system because of its simplicity, flat hierarchy and the avoidance of duplications (double subordination), because in this system instructions and orders are only given by the immediately higher and highest echelon, i.e., usually the founders. Due to the usually small number of employees, a clear division of competencies and tasks is thus generated. Disadvantages mentioned in the relevant literature, such as cumbersome, long official channels and communication routes, seldom exist in newly founded and young enterprises (at least at the beginning). During the growth process of young enterprises, the demands made on the structural organization will, however, change. Thus, over the course of time, insufficient, long and inefficient communication and decision-making channels can become a problem as the organization grows larger. [See also Allen (2003), p. 277 for identifying business processes in a start-up business as a starting point for establishing efficient organizational structures.] Potential guiding questions for developing an adequate structural organization for a new venture can thus be:

- How can tasks be broken down, and how can the resulting components be reassembled into smaller task complexes?

- Who should carry out the decomposition of tasks?
- Which tasks can be delegated? Which tasks have to remain with the founder?
- In what way and with which frequency should the work results be reported to founder management?
- How can it be ensured that the individual work results are orientated towards the overall goals of the enterprise?

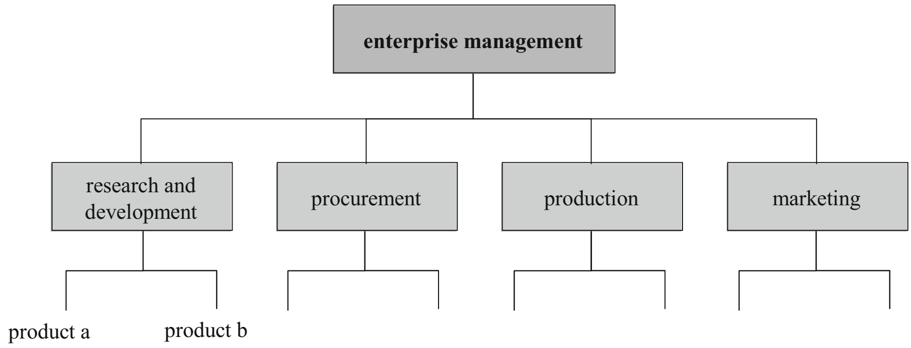
Specialization, delegation and coordination are essential parameters for developing different organization concepts, forms or models. Generally well-known concepts are the *functional organization, divisional organization* as well as the *matrix organization.* These organization models in their pure form can be called basic forms. In practice, mixed forms predominate. The structural organization is then adapted to specific requirements which can lead to a mixture of different approaches. As the basic forms are, however, the starting basis for the organizational structure of many enterprises, some selected models are to be discussed in the following. Beginning with an, at first, barely structured, informal organization, it is above all the functional organization model which is of fundamental importance within the context of young enterprises. In addition, project organizations as well as team organizations are typically relevant organization forms in young enterprises. In this context, the possibility of organizational complementary structures within the framework of innovative projects should also be pointed out to established enterprises [See also Neugebauer (2008)]. This may, for instance, include the concept of internal venture teams, which is closely connected with the idea of corporate entrepreneurship (concerning this latter form this book will not go into detail). For organizational complementary structures we refer, for example, to Kieser/Walgenbach (2003). In the following sections, we will concentrate in more detail on basic organization forms, the functional organization, project organization as well as the team organization with regard to their respective application possibilities, especially for young enterprises.

#### 5.1.3.1 Functional Organization

The functional organization is based on the single-chain organization. Its result is a **structuring according to functions,** such as *research, development, procurement, production, marketing, commercial administration* or *personnel*, i.e., this organization structure in principle is only function-oriented on the first hierarchical level. The subsequent hierarchical levels may follow a different systemization, i.e., a repeated functional orientation or also an object-related orientation (customer, product, region etc.).

Illustration 5-2 shows an example of a functional organization.

*Illustration 5-2:* *Functional organization diagram*




Due to the specific character of the single-chain system, instructions and responsibilities are undivided in the functional organization. There are *clear subordination conditions* as well as *few competence overlaps.* In addition, all areas are clearly demarcated. In this organization form, a *strong need for coordination* between the individual areas exists. Within the context of young enterprises, this *co-ordination* is normally carried out by *the founders.* The advantage is that the individual measures and decisions can be targeted by the founders themselves to their vision, aims and strategies. This approach can lead to the disadvantage of a very strong involvement of the founders in operational activities and processes and contains the risk of an overburdening of the founders as management capacity is scarce in emerging small businesses [Aldrich (1999)], especially if essential strategic tasks are neglected because of these daily operational burdens.

The functional organization is particularly suitable for one-product enterprises or enterprises with a narrow product range. **This basic model is suitable** for a *small enterprise size* with a *relatively stable environment* as well as a *small or homogeneous product programme.*

During the early phases of the enterprise development, in which at first an uneven or discontinuous, but still manageable growth can be assumed, the functional structure offers a simple and pragmatic organizational structure. The functional organization form described above is an ideal-type base model. This model can be adapted to the individual and situational requirements of an enterprise and complemented with elements of other organization concepts. Ultimately it is important that the organizational structure allows efficient internal activities and processes, promotes innovation capability and supports a successful operating in the market.

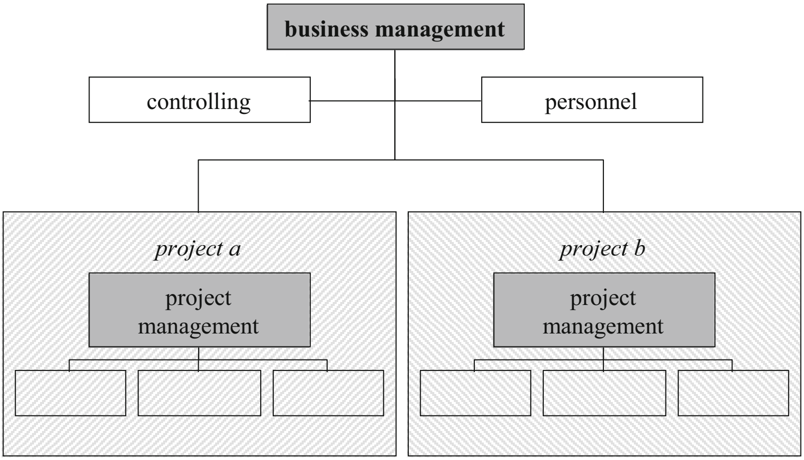
### 5.1.3.2 Project Organization

Projects can be characterized using different parameters. **Characteristics of a project** can be: its degree of *uniqueness,* a (usual) *time-limitation,* as well as a *relative novelty* (degree of novelty for the enterprise itself) with a *set time-frame,* and therefore a *defined beginning* and an associated *end*. It is the relative novelty which leads to a degree of *uncertainty* making an exact planning and structuring more difficult. For carrying out projects, various financial and personnel resources are required, which often are not sufficiently available for young enterprises. Nevertheless, simple forms of project organization can represent a meaningful organizational form for a young enterprise, especially in the early phases of development. Already for the start-up of an enterprise, the introduction of a product and the processing of, for example, individual customer orders can be organized as a project. The practical forms of projects are, however, context-dependent and individually related to the young enterprise in question.

**A pure project organization** is an *object-oriented organization* or *divisional organization* and has an object orientation or an object-oriented structuring of tasks. As the object, one or several projects are assumed. Like the object-oriented organization, the objects (projects) are equipped with the necessary competences for managing and executing the projects (decision rights, control rights, instruction rights) as well as resources (financial, personnel, knowledge etc.). A formal project management serves as the contact unit for higher hierarchical levels, with project members being directly subordinated to the project management. In the base model of the object-oriented organization, so-called central departments are formed to support and coordinate the individual objects. The central departments represent services for the individual objects, e.g., in the form of staffs, which may be equipped with different competences in relation to the individual objects. The central departments are designed to help avoiding duplicated tasks and can sometimes be considered as internal service providers [Kieser/Walgenbach (2003)].

Illustration 5-3 shows the example of a project organization [Following Schreyögg (2003)].

***Illustration 5-3:*** *Example of a project organization*




In case of young enterprises opting for a project organization, the formation of different central departments is possible. In some cases, one or two central departments can already be found in young enterprises, which support the individual projects in their work, for instance, a department of controlling or personnel matters.

From the theoretical point of view, the project organization differs from the basic form of the object-oriented organization through its time-limitation. In contrast to a project-organization, in an object-oriented organization the object (e.g., a business unit focussing on a specific business line), for instance, is formed by product A, which in principle doesn't have a time-limitation. In the pure project organization, the object is a project which is time-limited. Especially within the context of young enterprises, long-term projects can, however, also be assumed (e.g., the development of a new drug in a biotech start-up). Therefore, a project team does not have to be dissolved when the project is completed. On the contrary, follower projects can be handed over to the project team, so that the organizational unit can exist long-term. From the theoretical point of view, a project organization could then be defined as a string of individual self-contained projects [Schreyögg (2003); Bea/Haas (2005)].

Basically, the advantages and disadvantages of a divisional organization also apply to the project organization. One of its advantages is a strong object orientation with a simultaneous high equipment of competences for reaching the target. For example, there may be cost advantages from learning by concentrating on only one single project. Disadvantages for the whole enterprise can be the result of an egoistic behaviour of the individual objects or projects, as the achievement of the aim of the individual project is at the forefront for the project members. However, it should be noted that in particular with young enterprises the organization in many cases has a manageable size, in particular with regard to employees and the number of projects. As a rule, the founders act as central coordination and control elements. The individual project tasks must be coordinated purposefully and oriented towards the overall strategic goals of the enterprise. Sometimes, mediation between different projects or employees is necessary in order to minimize or eliminate potential target divergences.

#### 5.1.3.3 Team Organization

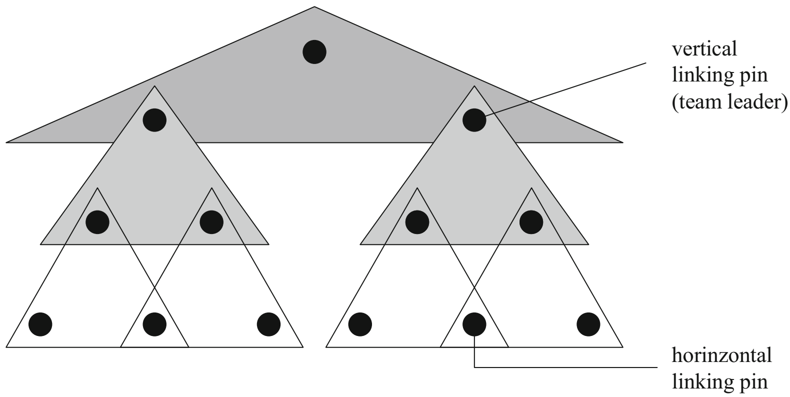
The form of the **team organization** is characterized by a *transfer of competences* (decision rights, control rights as well as different instruction rights) *to groups* or teams in contrast to the usual transfer to individual persons. Teams can be *characterized by the following factors: duration of the team existence* (fixed term/open-ended), the *number of members* (limited number of team members), *goal setting* (achievement of specific goals), *high autonomy* (acting on one's own responsibility) as well as the working-method as *team work.* The individual characteristics define a team, where different focal points can be set regarding its structure. It is important that the members of the team are selected in a way that they contribute as good as possible to achieving preset targets. In order to reach these targets, the team members have different specific competences. A clear demarcation of teams and project groups is not always possible.

In addition to the basic form of the team organization, which in practice exists in different variations, there are further forms. In connection with young enterprises, the *system of overlapping groups according to Likert* as well as *semi-autonomous teams* can be named.

The **system of overlapping groups according to Likert** is primarily characterized by a *hierarchical organizational structure* as well as *different specialized teams which may intersect horizontally and vertically.* The intersection is formed by persons who work as members in two different teams. These persons are named *linking pin*s as they link two groups via themselves [Likert (1972)].

Illustration 5-4 is designed to show the general structure of the concept graphically.

***Illustration 5-4:*** *System of overlapping groups according to Likert*




Linking-pin team members take on a coordination and harmonization function, as they have information about two teams and areas at their disposal. They can help to avoid duplications of work. Decisions are made in the group on the lowest possible hierarchical level in order to achieve decisions "on site" and at the level in question. Due to an assumed little developed hierarchy within the team, occasionally decisions are delayed or not made at all. In this case, the team leader (vertical linking pin) should make a decision according to Likert. Using this approach means that the competences of the team leader with regard to the team members have been increased. In principle, the chain structures of the command relations have been mixed, as the decisions of the team leader then theoretically represent selected competences as we find in a single-chain system. To avoid this disadvantage, a communication- and employees-oriented enterprise culture is advantageous, as well as a cooperative style of leadership, as in the project organization. The model according to Likert can also be combined with other organization forms to reflect the individual requirements of a new enterprise. Within the context of young enterprises, the employment of linking pins and thereby the intersection of different groups sometimes appears advantageous as it facilitates an overall target-oriented coordination. With regard to the employees, the aim of coordination efforts should be clearly defined and communicated accordingly. The founders are the central persons whose task should be to set the aims for the individual linking pins. In young enterprises, teams could stand side by side in a flat hierarchy and be linked horizontally through individual linking pins. The founders have to be decisive vertical linking pins who, if necessary, can also make decisions for the group, focussing on the targets at which they are aiming.

A further form of team organization within the context of young enterprises is the concept of **semi-autonomous teams**. Semi-autonomous teams primarily can be found in *industrial production environments* at the shop-floor level. In principle, they do not form a structural organization. On the contrary, specific, selected competences are transferred to semi-autonomous teams, which apply only to a small part within the enterprise. Examples of semi-autonomous teams can be found in automobile production. There, production processes are carried out independently. The autonomy can refer to the process of work planning, but also partially to the work organization. A semi-autonomous team is responsible for the fulfilment of the task area transferred to it. In young production enterprises semi-autonomous teams can be employed to contribute to the enlargement of the task spectrum of the employees working in the production, too. The transfer of task complexes can help to generate a sense of responsibility and motivation, particularly under sometimes monotonous working conditions.

Teams can be formed in almost all areas of a young enterprise and employed for different purposes. However, possible conflicts should be taken into consideration, which may be caused by personal or formal and informal rules. When composing the team, the conflict potential as well as the possibilities for solving conflicts of the individual team members should be taken into account. Beyond the routine work tasks, they can serve to improve the quality of the individual sectors of business operations. Within this meaning, *quality circles* are a proven medium, which can also be used by young enterprises.

In total, the organization concepts listed in this chapter can be employed within the context of young enterprises as required. This applies to the functional organization as well as to the individual forms of project or team organization. On the basis of the individual characteristics of a specific young enterprise, different variants and development possibilities offer themselves. The important thing is that in the case of a growing young enterprise, a structuring of the organization is carried out. Organizational changes are necessary the earlier, the more dynamic the enterprise growth. All things considered, different requirements can be relevant. For instance, it can be necessary that the organization form offers flexibility to be able to react faster and more purposefully to changes in the environment. However, there is no universally applicable organization concept which can be used with equal success by any young enterprise. [For example, the studies by Sine et al. (2006) and Ebben/Johnson (2005) indicate that there may be considerable heterogeneity in organizational structures and levels of business performance in new ventures with no identifiable single best form to address the field of tension between organizational efficiency and flexibility in turbulent entrepreneurial environments.] On the contrary, the organization structures should be developed customized to the young enterprise in question.

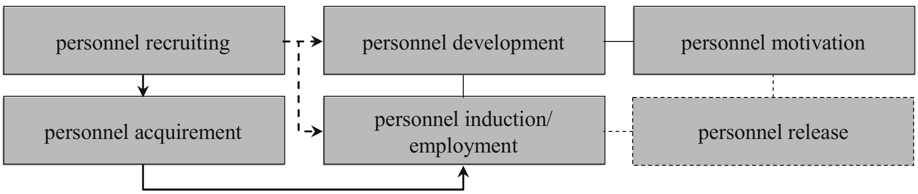
## 5.2 Personnel Planning and Human Resource Management

For growth-oriented young enterprises, personnel planning and management are of fundamental importance. In particular, in the phase of early development the new venture needs to prepare for future – sometimes rapid – growth of its business for which additional manpower in new operations and additional management talent beyond the founders will be needed. [See Joyce/Woods (2003) for an expert discussion of managing enterprise growth from a human-resource management perspective.] Personnel management comprises many and diverse tasks. **Personnel management** in this context means *to align the actions of all employees towards the common enterprise goals.* Starting from a careful and well-founded planning (e.g., in the context of the founder's business plan) as well as personnel employment, the personnel management entails the *development and promotion* of employees as well as their *motivation* to *employees leaving.* [For a survey of these essential issues in personnel management in small and emerging ventures, see Heneman et al. (2000) and Cardon/Stevens (2004).] Aside from possible insolvencies of young enterprises, the lay-off of staff is mostly still of secondary importance in this phase of enterprise development. In the personnel context wrong decisions can lead to high costs as well as possibly legal consequences for the entrepreneur and may threaten the existence of the enterprise in an extreme case. Therefore, even enterprises with only a few employees should pay special attention to this area.

Questions of personnel management arise soon after the personnel requirement has been established and new employees have been successfully acquired. To maintain or to strengthen the performance motivation of the employees is a central task of personnel management. To realize a long-term binding of qualified employees, it is important to ensure that they identify themselves with the enterprise and think and act in the interest of the enterprise (*organizational commitment*). A personal, open and performance-oriented enterprise culture is often characteristic for young enterprises. For young enterprises there is usually little time left for long- and time-intensive team consultations, as they often take place in large enterprises. Employee motivation is above all formed by the leadership style of the enterprise founders, who as a rule take on the function of role-models. The creation of material and non-material incentive systems is important for the motivation of the employees within this context. At the same time, the promotion of performance and an openness to innovations of the employees for generating a long-term enterprise success is of crucial significance. Namely, resources, in particular human resources, need to be acquired and combined so as to build a base from which distinct organizational capabilities (e.g., a start-up's engineering competences and market knowledge in solar energies) evolve to build a competitive advantage [cf. Brush (2001)].

The starting point of personnel management in young enterprises is formed by the **personnel planning** according to the *type and number of required employees.* The essential target of the personnel planning is to acquire the right employees for the young enterprise concerned and to attach them to the enterprise, as whether a young enterprise can operate and grow successfully in the market depends decisively on the qualification and the commitment of the employees. First, it should be investigated for which tasks and in what number people must be employed, and how they need to be acquired. In concrete terms it is to be determined which tasks the founders must take on by themselves and which operational activities can be delegated to a definite number of newly employed people. Many further questions will arise in this connection, e.g., what an intelligent labour division could look like, and what is the cost-benefit-ratio for investing in employees. From these questions the young enterprise will derive a specific personnel planning. Illustration 5-5 shows that personnel planning and management can be analysed into various steps. Ideally, it starts with the determination of the personnel demand of the enterprise, the personnel recruitment, continues with induction and employment, development as well as motivation and finally ends with their release. In practice, these phases are mutually interdependent. As an example, the employees' motivation cannot be seen as a single, isolated step but represents a core element of the whole process of personnel management. Also, personnel development of suitable employees within the enterprise (directly following the determination of personnel demand) is feasible, so that there is no need to carry out the step of personnel recruiting.

***Illustration 5-5:*** *Personnel planning and management*



### 5.2.1 Personnel Requirements

As it forms the foundation quantities of **personnel requirement planning**, the required *number and qualification of the employees, determination of the time period, employment location* as well as *costs* have to be taken into account. Regarding the aspect of costs, it should be examined whether the returns from an envisaged personnel employment will at least cover the personnel costs in the short-term, or whether long-term profits can be generated. The number and structure of required employees can be derived from the turnover planning and type and quantity of the planned tasks to generate this turnover, i.e., founders need to consider all operative steps and tasks alongside the value chain from procurement of input material to after-sales services to determine how much manpower will be needed. Typically, personnel requirement planning is done in the context of overall business planning when preparing the initial business plan for the enterprise [Allen (2003)].

It is important to note that before-the-fact identification and specification of human and other resource needs to establish a new business enterprise suffer from a lack of predictability [cf. Stevenson/Gumpert (1985)]. Personnel planning is particularly difficult for industrial enterprises because of the complex operations with adequate production quantities which are difficult to forecast. In the service sector, the personnel requirements can be calculated in a somewhat simpler manner from the planned turnover, which is divided by the calculated daily rate for working with customers and the possible number of working days; however, the lack of visibility of future turnover and customer demand still remains. Often, start-ups use proxy data from similar enterprises in their business planning in general, and in particular in personnel scheduling. For example, on the basis of comparative key data typical for the industry concerned, the personnel requirements can be established for further tasks, e.g., in administration and distribution.

As the new enterprise develops the task of the personnel requirement planning involves comparing the actual employment with the target employment in a way that the actual requirements can be determined, i.e., any necessary new or replacement employees or a reduction of the existing personnel through employees leaving. In practical terms, a survey can be helpful in the form of a simple tabular calculation of the personnel requirements for a certain period. Then it is useful to carry out more detailed planning. On the other hand, it is also necessary to generate sufficient flexibility margins to be able to react quickly to changes inside and outside the enterprise relating the above-mentioned lack of predictability of future resource requirements in new ventures. For instance, external changes can have an influence through price decreases or innovations of the competitors. Internal changes are, for example, caused by growth or changes in the work processes. The following Table 5-1 shows the calculation of the personnel requirements on the basis of a simple outflow/inflow calculation.

*Table 5-1: Personnel planning and management: Outflows and inflows*

| **Outflow** | | **Inflow** | |
|---|---|---|---|
| Department/business area: | | Period: | |
| *Labour force:* | | | |
| *Types of outflow:* | Number: | *Types of inflow:* | Number: |
| – Promotion<br>– Relocation<br>– Training/further training<br>– Maternity protection<br>– Dismissal<br>– Resignation by employees<br>– Retirement<br>– Miscellaneous | | – Promotion<br>– Relocation into department<br>– Return from training/further training<br>– Termination of maternity protection<br>– Take-over from training relationship<br>– Permanent employments<br>– Miscellaneous | |
| *Sum of outflows:* | | *Sum of inflows:* | |

One point of discussion in young enterprises as regards meeting personnel requirements is whether the company wants to employ its own permanent employees or whether the personnel requirements should be met through external labour (so-called **freelancers),** or by removing and transferring sections of the value chain onto a cooperative or reciprocity network. Reciprocity means benefiting each other: In **reciprocity networks,** cooperation occurs between in reality competing enterprises, which can bring advantages within the start-up context, as no employees need to be kept in reserve. On the contrary, work-loads are distributed cross company over other enterprises of the network so that projects or tasks can be carried out by a commissioned enterprise acting as the project initiator with the help of reciprocity networks. The trust in the network partners serves as the basis of reciprocity networks. A beneficial realization as a win-win-situation can only be generated through trust. Reciprocity network relationships can be exploited by individual network partners for their own exclusive advantage. Therefore, relevant formal and informal regulations have to be introduced which should help to minimize such risks.

**Types of Employment**

Within the context of personnel requirements, an important issue is the type of employment. Depending on the aims of the young enterprise, the available financial resources, the work load within the context of the required working time, as well as the planned contractual binding, different types of employments can be identified:

- Working time
  - Full employment
  - Part-time employment/marginal employments
  - (e.g., as temps)
- According to contractual binding
  - Fixed employment (time-limited, open-ended)
  - Freelance
  - Contract work/hired work
  - Outsourcing

The main categories are *full-employment, part-time-employment, contracted workers, marginal employments,* temps as well as *freelancers* and *outsourcing* within the meaning of transferring sections or activities to a network or other external parties. It must also be decided whether the young enterprise would like to employ its own permanent employees full-time or part-time. Alternatively, the personnel requirements can also be met via a time-limited employment, freelancers, contract/hired labour or outsourcing. A personnel bottleneck can also be temporarily resolved through the overtime of those who are already employed.

Personnel decisions are investments to secure the future of the young enterprise. At the same time, the fixed employment of a full-time staff member will create costs, without producing any immediate turnover. When scheduling labour costs in their business plan entrepreneurs should be aware that in addition to the gross salary to be paid, also ancillary personnel costs have to be considered. Note that the composition and volume of these cost items differ substantially across countries in Europe, largely depending on the structure of the social security systems.

For example, in a 2008 survey of labour costs in the member countries of the European Union non-wage costs ranged between 9 and 17% of gross earnings in Malta and Ireland, and 48 and 50% in Sweden and France [http://epp.eurostat.ec.europa.eu; www.destatis.de]. I.e., from the viewpoint of young enterprises as employers the calculation of personnel costs may look different, depending on the country in which business operations take place (e.g., different employer contributions to social security systems like retirement provisions or health insurance). Table 5-2 shows typical non-wage cost items for companies in Europe.

***Table 5-2:*** *Examples of auxiliary wage cost items in Europe*

| Position | Amount |
|---|---|
| *Professional corporation* | |
| *Employer's national insurance contribution:* | |
| *health insurance* | |
| *old age pension insurance* | |
| *unemployment insurance* | |
| *illness* | |
| *Sum of auxiliary salary costs* | |

When scheduling total labour costs in their business plans, start-up enterprises should appreciate that the burden of **auxiliary labour costs** may amount to up to 50 percent of gross salary (as of 2008 France had the highest non-wage labour costs of 50 Euro per 100 Euro gross earnings, the EU-27 average is 36 Euro). Finally, in this context it should be noted that the founders are often personally liable for the punctual payment of the social insurance contributions and salary taxes. This may apply irrespective of the chosen legal form.

For the young enterprise, which would like to avoid the costs for permanent appointments, there are many alternatives. One example is the possibility of outsourcing or the removal and transfer of certain business operations onto external suppliers and partners (this is a "make or buy" decision). For outsourcing, mainly operational tasks, such as, for example, accountancy or EDP-tasks, can be considered. In cooperative networks, such enterprises often cooperate which are really competitors. This can be advantageous within the start-up context, as no labour force has to be maintained.

Each of the above listed forms of employment is associated with specific advantages and disadvantages. The advantages of permanent employment against freelance work are, for example, a possibly longer-term binding of the employees and resultant lower fluctuation due to a perceived job security. In Germany and other European high-wage countries, the comparatively high fixed costs due to fixed wages or salaries and the high auxiliary wage and salary costs can be considered as disadvantages. The availability of freelancers on the other hand may be limited, as they normally work for other companies which may cause problems of availability. Too, the advantages of outsourcing need to be weighed against potential long-term drawbacks. For example, outsourcing may lead to deficits in building own strategic capabilities within the enterprise or the threat of outsourcing partners to become direct competitors in the future; this may be less of a concern for areas like external accounting services but should certainly be considered when it comes to areas belonging to the strategic core business of the start-up enterprise. Overall, the founders should weigh the advantages and disadvantages for young enterprises very carefully before making a personnel-based decision. Based on the established personnel requirements and the determination of the planned types of employment, the planning of *personnel acquirement, personnel introduction and employment* as well as the *personnel development* can be carried out.

### 5.2.2 Personnel Recruitment

The **personnel recruitment** will be carried out on the basis of the established personnel requirements. The criteria on which the personnel requirement planning has been based play an important role here, such as the number of employees and their qualifications, duration of employment, employment location and costs. Management theory often distinguishes between *internal* and *external measures of personnel recruitment*. [See Carroll et al. (1999) for typical recruiting instruments employed in the domain of small enterprises in particular.]

Characteristic features of **internal personnel recruitment** are:

- Filling the vacancies with employees from the enterprise
- Internal advertising of a post
- Employees assessment (relocation, promotion)
- Personnel development (relocation, promotion).

Whilst **external personnel recruitment** is characterized by:

- Filling the vacancies with external personnel
- Job advertisement (newspaper, internet)
- Personnel mediator (recruitment agencies, job centres, head-hunters)
- Personnel leasing or contract work
- Contact to training centres

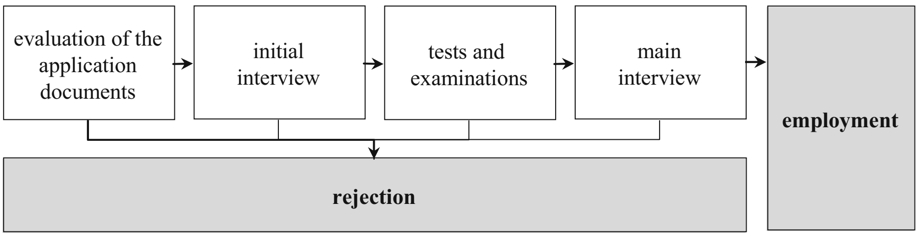
**Personnel marketing** comprises the choice of media (type, extent) for reaching potential employees. Tools to be employed are, for example, *targeted formal and informal contact with potential multipliers, word-of-mouth promotion, newspaper inserts, vacancies advertised on the internet* and *internal posters offering vacancies.* In their recruitment of employees, young enterprises generally restrict themselves to job advertising or the homepage of the enterprise [Moog (2005)]. An additional effective and cost-saving measure can consist in directly addressing multipliers such as professors, graduates and students at universities and colleges. With their consent, jobs can also be advertised there through the faculties.

With regard to personnel recruitment, sometimes there may be disadvantages for the young enterprise compared with larger established enterprises due to a possibly lower salary offer, fewer opportunities for advancement and perhaps a reputation which has still to be built up. Like the acquisition of other resources, these disadvantages strategically have to deal with typical liabilities of newness of young enterprises. Potential employees may be unsure about the sustainability of the new venture in the long run, do not know anything about its HR management practices, or doubt that there will be prospects to build a career in a small firm [Katz et al. (2000)]. Therefore personnel marketing should highlight the advantages of the young enterprise clearly to potential employees and use supporting measures (e.g., presentation of the enterprise at trade-fairs), to make information available. As young enterprises often have no track record, potential employees often are won through their own self-motivation and their interest in the subject or business idea. Other advantages of the young enterprise could be the potentially responsible, independent and many-sided fields of activity, the personal family atmosphere or the direct, open communication with flat hierarchies.

A further area of personnel recruitment is **personnel selection**. The selection of potential employees can be carried out in a systematic, multi-step process. It starts with the arrival of the application documents and ends with a possible job engagement.

The following Illustration 5-6 shows a possible systemization of the personnel selection process.

***Illustration 5-6:*** *Systemization of a personnel selection process*




In the process of personnel selection, the requirements of the position that needs to be filled (e.g., trainees, unskilled employees, skilled employees and executives) have to be matched with the qualifications of the applicants. A job description and profile of qualifications serve as a basis. The quality of the selection decision depends on the accuracy of the formulations in the requirement profile, the possibilities of verifying applicants' qualifications and the comparability of the results with the previously prepared profile. The number of steps and their contents normally depend on the job requirements, the addressed applicant group and the personnel policy of the enterprise. It is particularly important to choose suitable methods for selecting employees to be able to compare the capabilities and skills of the applicants with those of the job specification.

In practice, the size and quality of the applicant group also influences the form of the selection procedure. In the case of very large applicant groups (e.g., responses on job advertisement on the internet) an even more intensive and careful analysis and evaluation of the qualification profile will be required, as experience has shown that the total number of applicants will only contain very few applicants with the desired key qualifications for the vacancy. If only a few applicants with the desired qualifications should be available, a costly selection procedure is mostly dispensed with.

In practice, most young enterprises only choose the main interview as a selection procedure for reasons of cost, or because they are not familiar with the other tools of applicant selection like assessment centres. Therefore the engagement of an applicant is often not decided through a systematic assessment according to specific criteria, but ultimately by the empathy or the gut feeling of the founder. The most frequent mistakes are made when drawing up the contract of employment. This can result in an increase in the costs for the young enterprise or a decrease of turnover on account of bad customer management by new employees. Therefore, for young enterprises it may be of long-term advantage to familiarize themselves with the different tools of personnel selection in a way, that they are able to employ them systematically and purposefully. Possible tools of the applicant selection are, for instance, the *analysis and evaluation of application documents,* the *main interview,* different forms of *test procedures, work samples* as well as *assessment centres.* For applicant selection we refer, for example, to Cascio (2003).

After completion of applicant selection, the drawing up of the employment contract is important. In a young enterprise, it should be kept simple, clear and concise, not exceeding two to three pages in volume. The core component of the employment contract should be the description of the area of activity, start and duration of the employment relationship, trial period, remuneration as well as working hours and holidays. In addition, specific measures for the development of the employee can be agreed. When the employment contract has been signed, the founders must realize that they are bound to keep a personnel file.

### 5.2.3 Personnel Induction and Employment

Within the context of young enterprises it is usually the founders' task to instruct and employ the new personnel according to their qualifications. Personnel induction and employment mainly deal with the following task areas:

- Assignment of manpower and work places
- Daily personnel management
- Adaptation of work and work conditions to the employees
  - Division of labour
  - Organization of place of work
  - Organization of working hours

Basically, one can distinguish between *fixed* and *flexible* possibilities of employing the personnel. Personnel employment which is more-or-less fixed means that the employees are active at one location at a certain time and for a definite duration. Individual criteria, such as the starting time, cannot be determined flexibly by the employee himself. In this case, employees must be at a place of production at defined times so that a smooth production process is possible. In contrast, flexible personnel employment, i.e., *flexitime,* allows the employees to determine themselves, for instance, start and end times within a pre-defined framework.

Another possibility of generating a flexible work employment, e.g., in case of a season- or project-related demand, is the use of a *work-time-account.* A **work-time-account** can be understood as the *juxtaposition of the total target work time* (daily target work time x number of working days within the accounting period) *and the total actual work time* (daily actual work time x number of working days in the accounting period) of an employee, *during a defined consideration period* (month, quarter, year etc.). At the end of the consideration period, a balance is formed, which will show positive hours or time credits or negative hours or time deductions, which will be credited or deducted for the employee in the following period. Thus the tool of work accounting contributes in a positive way to make the working time in an enterprise flexible. Work loads as well as work peaks can be distributed in a better way with the aid of the working time account, which will lead to a flexible work time, in particular in enterprises whose main work peaks are distributed on the basis of seasons or projects.

For young enterprises where project-related work loads occur in particular, flexible work time models can be advantageous. The relevant period can be a month, quarter or six-months. In the early phases of enterprise development, employees may have to increase their performance with regard to working hours, even over a longer period of time. One can imagine that for employees in young enterprises high positive credits can sometimes be collected in the work-time account, if a temporary high work load is required. Then credits of the account either can be passed on to the account of a following period and set off against the time to be worked in this period with a lower time demand, as, for instance, during a project which is not critical in terms of time, or it is possible to remunerate the additional work. In this decision, the financial conditions of young enterprise must be taken into account.

### 5.2.4 Personnel Development

Empirical studies have shown that in particular the qualification as well as the motivation and involvement of the employees based on sound personnel management contribute to the economic success of an enterprise. [See, for example, MacMahon/Murphy (1999) for the relevance of adequate HR management practices for the success of small, growing enterprises; cf. Clarke et al. (1999) for the specific role of management training and development in small enterprises.] Therefore, the area of **personnel development** is of special significance for young enterprises. Essential aims of the personnel development are the *training and strengthening of technical, methodical, initiative and social competences* as well as developing the specific *enterprise-relevant key qualifications* of the employees. *Technical competences* comprise knowledge related to a specific field and inter-disciplinary knowledge, as well as the capability of linking, strengthening and critically examining all acquired knowledge and applying it to practical actions. *Methodical competences* refer to the capability of generating and utilizing specialist knowledge and handling problems in general. *Social competences* refer to skilfulness in a social setting and behaviour in human relationships. Above all these include the capabilities to communicate, cooperate, motivate and convince, as well as the capability to manage conflicts and have a critical faculty. *Personal competences* comprise inner attitudes and characteristics of a personality, which cannot be assigned to one of the other three capability areas. This may, for instance, include the capability of handling oneself critically and reflectively, i.e., to scrutinize one's own knowledge, capabilities and skills and be able to initiate possible measures, e.g., for obtaining qualifications or changing one's behaviour. Through the relevant *initiative competences* it will be possible for the mentioned competences above to become effective. In this way, the measures for personnel development will serve a target-oriented improvement of the qualification of an employee or a group of employees.

Measures for **personnel development** can, for instance, be:

- Training and further training (e.g., through seminars)
- Training of mediators (main negotiators in cases of conflicts)
- Coaching, mentoring, supervision
- E-learning
- Induction programmes

- Programmes for the next generation of executives
- Organization and change of work place with enrichment of tasks (e.g., through project work)
- Development talks

An essential aim of the measures for personnel development is to lead to greater competence and responsibility as well as to an increase in the motivation of the employees themselves. It is a question of achieving a target-oriented further development of the employees, based on innovative methods and skills. At the same time, the individual family and career planning of the employees has to be considered. Even if changes in the organization are planned, young enterprises can employ measures for personnel development in a way that these measures accompany and support the changes. Within this context it may be advisable that already in the early phases of the enterprise development incentives are created which are designed to motivate and bind employees.

### 5.2.5 Personnel Motivation

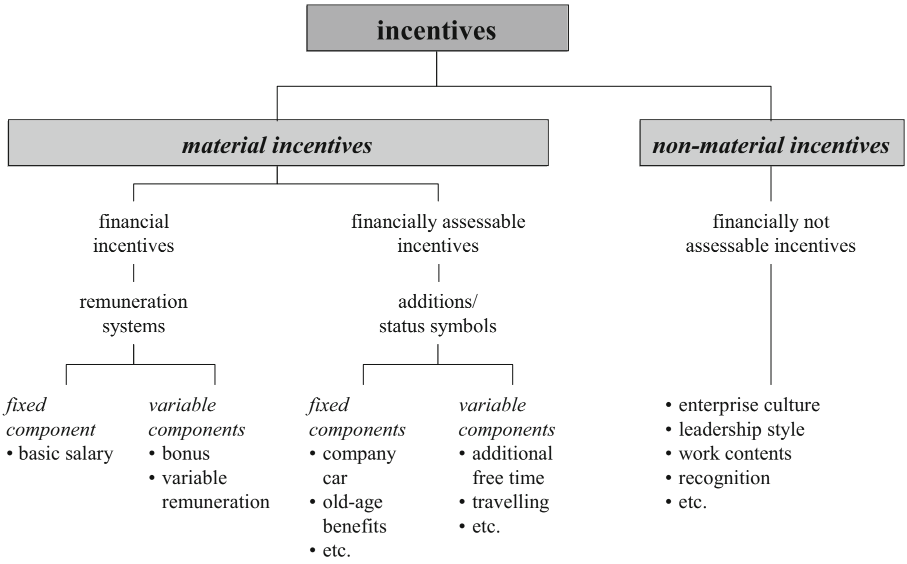
Generally **motivation** needs to be interpreted as the *readiness to take on tasks in order to prove one's own capabilities and competences.* Leadership behaviour, enterprise culture, personnel motivation and personnel satisfaction are closely connected.

The business management literature distinguishes fundamentally several incentive systems for motivating employees. Most importantly, it should be examined which incentives are particularly relevant for young enterprises. The introduction of an operating proposal system with a bargaining agreement and premium system barely enters into the consideration of a young enterprise with only five employees and would probably find no great acceptance amongst the employees. However, other forms of material and non-material incentives may be suitable to match the aims of the entrepreneurs and employees.

Greater *decision competence* and the *freedom to choose working time and location freely,* belong to the **non monetary (non-material) incentives,** which are frequently used, especially in young enterprises, and are opposed to **monetary (material) incentives.** In principle, many and diverse opportunities for personnel motivation are available to young enterprises.

The following Illustration 5-7 shows a possible systemization [Plaschke (2003); also cf. Cascio (2003)].

***Illustration 5-7:*** *Classification of incentives*




### 5.2.5.1 Non-Material Incentives

**Non-material incentives** *elude a direct monetary evaluation.* They range from *enterprise culture* via *leadership styles of the founders* within the context of staff discussions, to the *work content* and a *praising recognition of work done.* As there usually are only few advancement or career opportunities in young enterprises due to the few leading positions and the normally flat hierarchy, other material and non-material incentives are in the foreground. An essential factor influencing the personnel motivation in the early phases of the enterprise development is the *leadership style of the founders* [MacMahon/Murphy (1999)]. The personality of the founders forms decisively the culture of the young enterprise. The relevant business management theory contains different approaches for the systemization of leadership styles. A classical approach presents the possible forms *from authoritarian to cooperative leadership styles* [e.g., based on the works by Likert (1977)]. In the **authoritarian leadership style**, the *operational activities are shaped and imposed by the superior* without participation of the employees. The superior makes a decision without giving any reasons and expects obedience. In the **cooperative leadership style,** the *operational activities are influenced by the cooperation of the superior and the employees.* Areas of responsibility and decision competences are transferred to the employees. The independent thinking and acting of the employees is encouraged. *Then delegation is the expression of trust* in the capabilities of employees and can thus have a positive effect on their motivation. In this context, **target agreements** are an important *leadership tool* to ensure that such a delegation is successful. The best for this purpose is if superiors and employees agree in writing which tasks need to be carried out for how long, by whom and with which resources. There are many intermediate forms between the two extremes of authoritarian and cooperative, such as the *patriarchal, participative or democratic leadership style.* [For different leadership typologies see, e.g., Burton et al. (2002).] Whilst authoritarian, patriarchal leadership styles were predominant in German start-ups after the Second World War, cooperative and participative leadership styles have been more frequent in recent times, particularly within the technology sector.

Another important factor for motivation is the discussion with employees, which should already represent a fixed and regular element of personnel management in young enterprises. They offer the opportunity to founders to give employees feedback about their performance in a well prepared and structured form, to point out new work targets or tasks, as well as prospects for further development.

**The core element of discussions with employees** are *target agreements* which will fulfil a series of tasks, e.g.,:

- Technical help and instructions for carrying out tasks
- Verification of targets achieved so far (establishing deviations)
- Introduction of adaptation measures which may have become necessary
- Passing on internal information within the organization
- Feedback to employees regarding their work performance
- Feedback from employees with regard to their work expectations
- Creation of a "we-feeling".

Aims should not be pre-set but agreed with the employees. To have a positive effect on the motivation of employees, they should be measurable and transparent. From the employees' point of view, the aims must be realistic and also attainable with the necessary effort.

Young enterprises are mostly formed by the personalities of the founders. There is a close personal relationship and a strong commitment between founders and employees in young enterprises. The anonymity often found in large enterprises barely exists in young enterprises. However, the employees may also be exposed to a greater social pressure in the team and the controlling eyes of the entrepreneurs. Although the communication channels in young enterprises are advantageously short, they are not always utilized in close relationships. Too little is delegated, and the authority to make decisions is often too much concentrated on the founders.

As not only **performance capacity** but also the **performance willingness** of employees is important for the work result, the psychological dimension of motivation becomes crucially important. The degree of performance motivation varies between people and influences quite individually their tendency to strive for success and to valuate their own performances. This is as challenge which has a good prospect of being met. An incentive consists in the fulfilment of a task in itself, which is therefore taken on with good commitment. Satisfaction is primarily provided by the work done *(intrinsic motivation),* the remuneration and recognition *(extrinsic motivation)* are of secondary importance. Due to the lack of decision competences, intrinsic motivation is rarely reconcilable with an authoritarian leadership style. Although most employees strive for recognition of work done well, a constructive criticism is also an essential incentive tool for improving the performance of the employees.

#### 5.2.5.2 Material Incentives

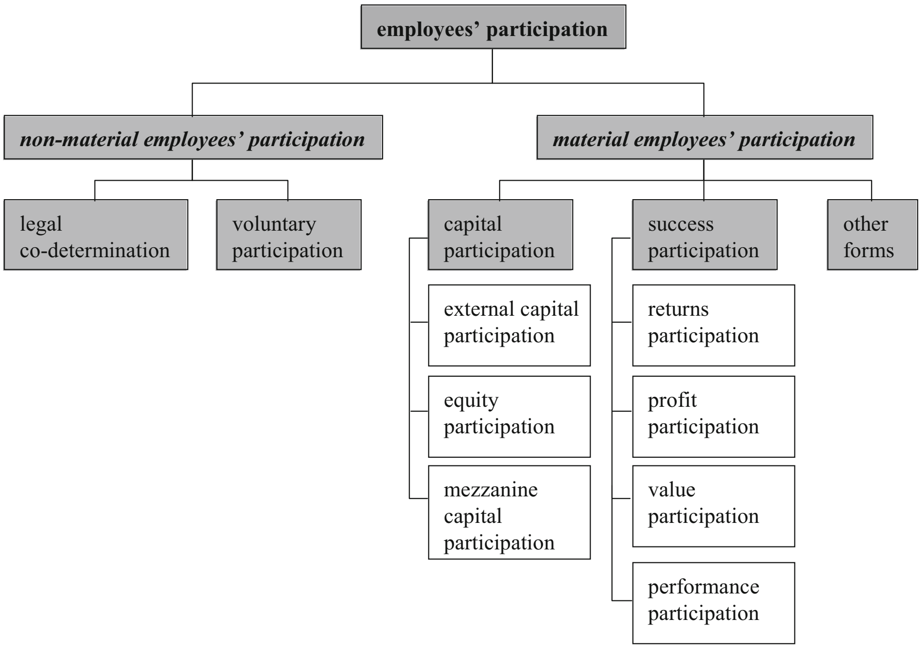
Young enterprises usually have less leeway when assessing fixed incomes in comparison to larger established enterprises. Therefore **financial incentive strategies in form of success or capital participations** are especially important for them. Moreover, *fixed and variable additional benefits* can be considered. A fixed additional benefit can, for example, be a self-administrated company pension scheme for employees or a company car. A company pension scheme is rather atypical for young enterprises. A variable benefit could, for instance, be the concession of additional leisure time. Employees' participations are financial incentives for motivation which are also used by young enterprises in different variations. They are designed to contribute directly or indirectly to an increase in the entrepreneurial success, for example, an increase in productivity, turnover or profit. In addition, an equity participation of the employees will lead to a strengthening of the equity basis of the young enterprise.

An employees' participation model based on clearly defined, transparent regulations and procedures can contribute to a sustained security and growth of the enterprise. A survey of the most important forms of employees' participation plans is provided below:

**Forms of Employees' Participation Systems**
Two different types of employees' participation can be distinguished, **material** and **non-material.**

Illustration 5-8 shows different forms of employees' participation [a combination of the explanations of Berthel (1995): Kürten (2001); Backes-Gellner/Kay (2002)].

*Illustration 5-8:* *Systemization of employees' participation*




**Non-material employees' participation** can be defined as the *participation of the employees in the decisions of the enterprise* in which they are employed. The different forms of participation of the employees with regard to co-management and co-determination are indicators of a non material employees' participation. Two examples are forms of **legal co-determination** often found in industrial labour laws (e.g., formation of a works committee) and instruments of **voluntary participation** (extensive decision and information rights on a voluntary basis in the individual enterprise organization).

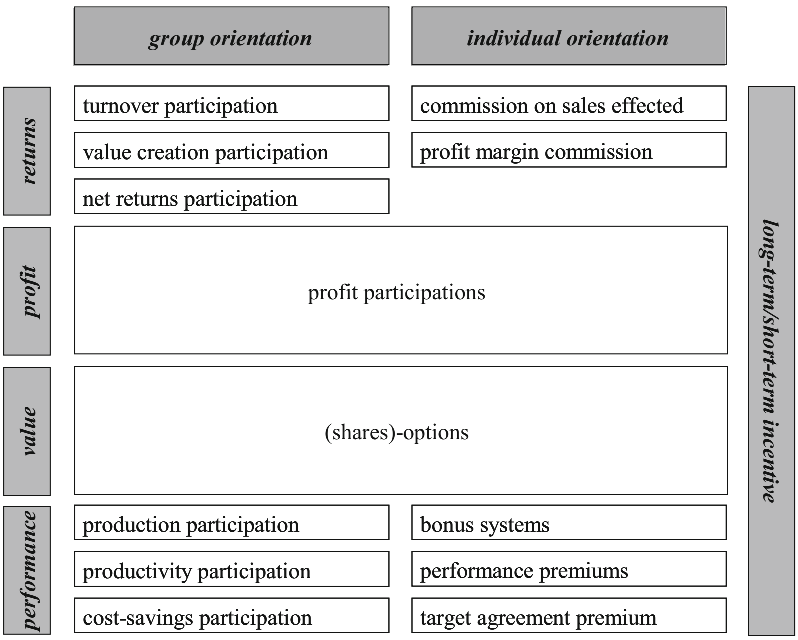
In contrast, **material employees' participation** can be defined as the *participation of employees in the success and/or equity capital of the enterprise* in which they are employed. Possible objectives of the use of material employees' participation can, for instance, be the increase of equity shares, the securing of liquidity, but also the strengthening of employee motivation and, in principle, an alignment of interests between enterprise founders and employees. Within the category of material employees' participation, one can distinguish between **capital and success participation** and other **remaining participation forms.**

**Capital participations** can be defined as *participation of the employees in the enterprise in the form of equity (e.g., employee shares), debt capital (e.g., employee loans) or mezzanine* *capital (e.g., participating certificates).* Capital participations allow the employees of the enterprise to participate *materially* in the enterprise pro rata. [See Kürten (2001) and Petty et al. (2005) for possibilities of employees and other stakeholders to participate in the value creation by entrepreneurial ventures.]

**Success participations** can be defined as *participation of the employees in the success of the enterprise.* These success participations are normally paid to the employees *in addition to their regular salary or wage according to a defined scheme,* if a fixed increase in the enterprise success has been achieved. Typical categories of success participation are: *returns participation (e.g., turnover participation and turnover commission), profit participation (e.g., premiums), value participation (e.g., stock-options) and performance participation (bonus systems).* The success participation in these four categories can be group- or individual-related [Kropp (1997); Kürten (2001)].

Illustration 5-9 classifies the individual forms according to the aspects of *group-orientation, individual-orientation* as well as *returns participation* (return), *profit participation* (profit) *value participation* (value) and *performance participation* (performance).

***Illustration 5-9:*** *Forms of success participation*




For information about the mechanism and conditions of employees' participation in small- and medium-sized enterprises see, among others, Backes-Gellner et al. (2002).

## 5.2.6 Personnel Release

While not on founders' minds when initially founding a new business and hiring people in the first place, personnel release is also important within the context of young enterprises. Particularly in small enterprises, possessing too high a staffing level and/or specific employees who are not motivated or willing to perform can lead to a threat to growth or enterprise permanence. This is so especially in view of the above-mentioned difficulties to make precise predictions about future resource needs of new ventures.

Any reduction of staff should be planned and carried out in a systematic and target-oriented manner. **Forms of personnel release** are, e.g., the *exploitation of natural fluctuations* in an enterprise such as termination of employment through resignation or *retirement* and *early retirement* of older employees, although the two last mentioned forms of personnel release seldom apply to young enterprises. Under these forms the posts which have become vacant are not filled again. In addition, an *employment freeze* can be introduced. One basic form of personnel release is the *dismissal or resignation.*

A **resignation handed in by the employee** is unproblematic. It must be noted that the resignation or notice to leave has to be given in writing and taking into account the relevant terms of notice. In the case of a **dismissal by the employer,** many different rules, laws and regulations usually apply, depending on the country where the enterprise is located. It is above all important to observe relevant regulations, e.g., of Employment Protection Acts.

In principle, dismissals are a complex topic, where a large number of mistakes can be made on the part of the founders. When a dismissal is imminent, legal advice should be sought to ensure, for example, that all laws and regulations are observed and that the dismissal will be legally effective. Which form of personnel release will be chosen will depend on the individual situation. If, for example, it is intended to dismiss employees directly (because they have repeatedly not fulfilled their obligations at work) or the enterprise is in a problematic economic situation (in which measures for restructuring and cost reductions must be taken) then a combination of the mentioned measures may be employed in order to release the personnel (the scope for combining different instruments to lay-off personnel will depend on the relevant labour legislation). In this case, the founders should take care that a socially reconcilable and planned personnel release is carried out designed to mitigate the hardship caused by the release to the employees. In such cases, the people concerned should be informed comprehensively and in good time. The information given to the employees in question must be transparent, extensive and above all be communicated in a timely manner. As releases in an economically problematic situation become necessary, special care should be taken to ensure a fair procedure. In this process, the founders have to accept a high social responsibility for the employees, in that any disregard of aspects in the personnel release, either in an individual case or in the case of an overall economic problem situation, can result in many different problems. In young enterprises, in particular, founders and employees closely work together, and in the case of a **non-transparent method of personnel release,** *de-motivation* and *anxiety* can arise among remaining employees. This often leads to *performance reductions* and a *deterioration of the enterprise culture.* In addition, it can occur that precisely the qualified employees leave the enterprise voluntarily because they don't feel secure any longer. This can lead to an undesirable *loss of know-how.*

# 5.3 Comprehension Test and Recommended Literature

## Comprehension Test

- Briefly explain the difference between structural and process organization. (5.1.1)
- How important are the concepts of informal and learning organization for young enterprises? (5.1.2)
- Outline the relevance of the individual concepts of specialization, delegation and coordination within the context of young enterprises. (5.1.3)
- Summarize the potential advantages and disadvantages of a functional organization for young enterprises. (5.1.3.1)
- What is understood by a project organization and how relevant is this form of organization for young enterprises? (5.1.3.2)
- Outline the organization form of the team organization and work out its importance for young enterprises. (5.1.3.3)
- How can a personnel planning and management process be defined? (5.2)
- Explain briefly the essential reference factors which have to be taken into account when planning the enterprise's personnel requirements. (5.2.1)
- Explain typical measures of personnel recruitment in young enterprises, taking into account their practical feasibility. (5.2.2)
- What is a working-time account and how important is its use for young enterprises? (5.2.3)
- Which measures of personnel development do you know and why are they so important for the young enterprise and its employees? (5.2.4)
- Discuss the advantages and disadvantages of different forms of employee motivation. Discuss whether you would personally prefer material or non-material employee motivation and why. (5.2.5)
- Why is the planning of personnel releases important? (5.2.6)

## Recommended Literature

### Organization – Standard Works

*Clegg, S. et al.* (2008): Managing and Organizations: An Introduction to Theory and Practice, 2nd edition, Thousand Oaks et al. 2008.

*Scott, W. R.* (2002): Organizations: Rational, Natural and Open Systems, 5th edition, Boston et al. 2002.

### Organization and Entrepreneurship

*Minkes, A.L./Foxall, G.R..* (2000): Entrepreneurship and Organization: thoughts on an old theme, in: Entrepreneurship and Innovation, vol.1, no. 2, 2000, pp.85–89.

*Sine, W. D. et al.* (2006): Revisiting Burns and Stalker: Formal structure and new venture performance in emerging economic sectors, in: Academy of Management Journal, vol. 49, no. 1, 2006, pp. 121–132.

### Personnel – Standard Works

*Cascio, W. F.* (2003): Managing human resources: Productivity, quality of work life, profits, 6th edition, Boston et al. 2003.

*Dowling, P. J./Festing, M./Engle, A. D.* (2008): International human resource management: Managing people in a multinational context, 5th edition, London 2008.

*Torrington, D./ Hall, L./Taylor, S.* (2007): Human resource management, 7th edition, Harlow et al. 2007.

### Personnel and Entrepreneurship

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# 6 Start-up and Growth Financing

Knowledge of financing strategies as well as the function and mechanism of different financing instruments is necessary to recognize and counteract in good time threatening financing crises and liquidity bottlenecks. Within this context, special importance should be attached to the optimization of the capital and risk structure during the phases of start-up and growth. The result of having low-equity equipment is often low economic strength (as became apparent, for example, in the large number of insolvencies of young enterprises during the period from 2000 to 2002 when the "new economy bubble" burst) [Rovenpor (2004)]. Numerous young enterprises had promising business models at their disposal, yet the main reasons for their insolvencies were financing problems which they were unable to resolve. The founders were in many cases not in a position to obtain external capital for overcoming the crisis and to manage their payment flows effectively. For example, for the US venture capital market, which is the world's largest, data from the National Venture Capital Association show that back in 2000 US VC companies had provided more than 100 billion USD while by 2003 the investment volume dropped below 20 billion USD [www.nvca.org; cf. also Timmons/Spinelli (2004)].

Against this background, it is necessary that enterprise start-ups develop and realize a suitable financing strategy to optimize their capital structure, taking into account their specific characteristics and objectives. The spectrum of criteria which determine founders' choices of equity and debt financing is wide and diverse. Examples of the **decision criteria** are, in addition to the total *financing costs: cancellation privileges, requirements for collateral, objectives of balance policy, specific co-determination rights* or *information duties as well as the sum of the required financing volume.* Taking into account lenders' demand for collateral to secure loans to new enterprises, the classical tools of debt financing are basically unsuitable for fast growing enterprises, as high risks in the start-up phase are usually not matched by exploitable loan securities; for these enterprises, venture capital may possibly be considered [Gompers/Lerner (2000); Denis (2004)]. A fundamental pre-condition for the acquisition of venture capital is, however, that the young enterprises demonstrate high, above-average development prospects and value improvements.

Starting with a general survey, this chapter will deal with the basic possibilities of financing for newly founded and young enterprises. At the same time, specific advantages and disadvantages for each financing alternative will be discussed.



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# 6.1 Survey of Financing Alternatives

## 6.1.1 Methods of Systematizing Different Types of Financing

In business management literature to date, no uniform definition of the concept of financing has been given, for the **systematization of the different types of financing** is carried out according to *different criteria.* According to the generally accepted interpretation of the concept, financing comprises all measures of procuring capital to fund business operations and future investments. Within the business management concept, however, financing refers not only to capital procurement, but also to the optimization of the capital structure and the payment flows. For enterprises in general and for young enterprises in particular, the focus lies above all on meeting the capital requirements through the purposeful employment of suitable financing alternatives – for the entrepreneur building a financial resource base for a new venture the particular challenge is the following: “because the exploitation of an entrepreneurial opportunity requires the acquisition and recombination of resources before the sale of output from that recombination, it must be financed” [Shane (2003), p. 161]. Table 6-1 gives a survey of basic systematization approaches as they can be found in the classical literature of managerial finance.

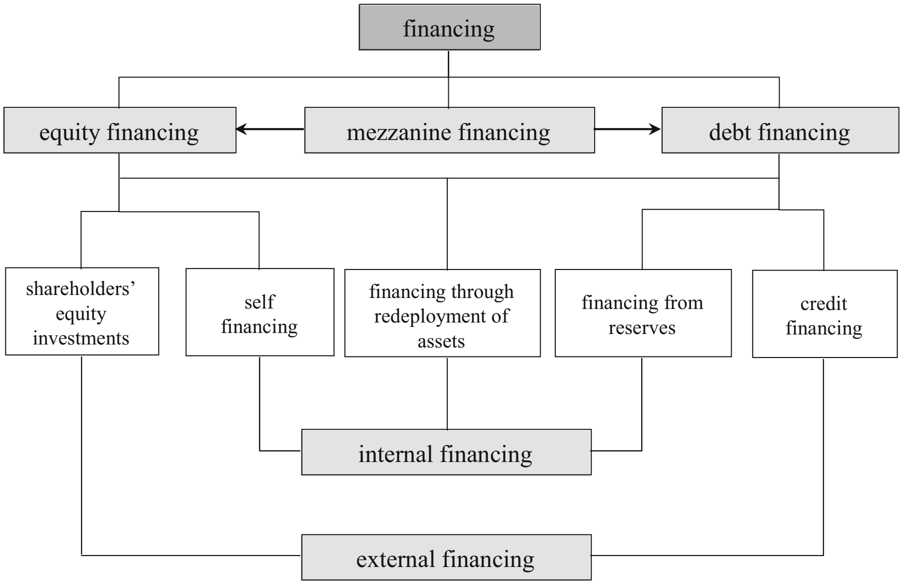
***Table 6-1:*** *Systematization of financing alternatives for young enterprises*

| Criterion | Forms |
|---|---|
| **Occasion for financing** | – Start-up financing<br>– Growth financing<br>– Take-over financing<br>– Reorganization of finances (debt adjustment) |
| **Legal position of capital providers** | – Equity vs. debt financing |
| **Origin of resources** | – External vs. internal financing |
| **Time pattern (terms)** | – Open-ended financing<br>– Time-limited financing<br>  – short-term: up to 1 year<br>  – medium-term: 1 to 4 or 5 years<br>  – long-term: over 4 or 5 years |
| **Frequency of financing acts** | – One-off, occasional financing<br>– Continuous, regular financing |

The classical literature of financial management usually adopts the classification, according to the legal position of the financiers, of equity financing versus debt financing or, according to the origin of the resources or capital, of internal versus external financing. Besides the originally owned and borrowed capital, the intermediate form of "mezzanine capital" has become increasingly important during the last few years, which is a hybrid financing tool that, as a mixed form, shows characteristics of owned capital as well as of borrowed capital.

The following Illustration 6-1 gives a survey of the connection between these forms of financing [according to Wöhe/Bilstein (2002); cf. Denis (2004)].

***Illustration 6-1:*** *Systematization of financing forms*




The equity capital, debt capital and mezzanine capital forms are usually taken into consideration as financing sources for an enterprise. **Equity investments** may be provided by *existing or new stock- or shareholders of the company* (external equity funding). In **self-financing,** *equity* is generated by *the turnover process.* Self-financing can be assigned to equity financing as well as to internal financing. From the entrepreneurial point of view, self-financing offers numerous advantages. The liquidity is conserved as no interest or dividend payments have to be made for capital providers. Moreover, the strengthening of the equity base improves the enterprise's credit worthiness and decreases the vulnerability to crises: "new ventures with more capital are more likely to survive, grow and become profitable because capital provides a buffer that entrepreneurs can use to respond to adverse circumstances” [Shane (2003), p. 162]. In addition, entrepreneurial independence is protected, i.e., from the influence of external capital providers. At least in the beginning, however, potential for self-financing in new enterprises is limited [Gompers/Lerner (2003)]. Similarly, **financing through the redeployment of assets** as well as **financing from reserves** can, in principle, rarely be considered by small and young enterprises with a limited asset base. **Credit financing** is simultaneously debt financing and external financing, comprising financing through bonds and, particularly in the case of small and new enterprises, non-traded commercial debt, e.g., bank loans [Berger/Udell (2003)].

Mezzanine financing, also called hybrid financing, is to be classified as an intermediate form between owned and borrowed capital. Typical forms of mezzanine financing are junior loans, dormant partnerships (private placement oriented mezzanine instruments), participating certificates as well as convertible loans and optional loans (capital market-oriented mezzanine instruments). Depending on the specific case, these financing forms have more the character of owned capital or borrowed capital. Their assignment in the balance sheet is made accordingly. Table 6-2 shows a systematization and characterization of equity and debt capital as well as mezzanine capital.

*Table 6-2: Differentiating characteristics of owned and borrowed capital*

| Criterion | Owned Capital | Mezzanine Capital | Borrowed Capital |
|---|---|---|---|
| **Legal position Liability** | – (Co-)owner<br>– Liability at least to the amount of the investment | – Various<br>– Liability possible depending on the form of contract | – Creditors<br>– No liability |
| **Remuneration** | – Depending on success<br>– Participation in profit and loss (dividends or capital appreciation) | – Depending on form of contract<br>– Interest claim, possibly<br>– Participation in profit and loss | – Independent of success<br>– Interest claim |
| **Possessory title (repayment obligation)** | – Residual claim (no repayment obligation) | – Depending on the form of contract | – Nominal claim (repayment obligation exists) |
| **Influence on enterprise** | – Controlling rights and votes | – Controlling rights and votes possible | – No controlling rights and votes |
| **Availability of financial resources** | – Open-ended | – Usually long-term | – Usually timed |
| **Ranking in case of insolvency** | – Lower ranking (liability capital) | – Ranking after borrowed capital | – Prior ranking |
| **Furnishing securities** | – None | – None or subordinated claim | – (Prior ranking) securities |

### 6.1.2 Systematization within the Context of Start-up and Growth

Within the context of initial venture formation, start-up, and later growth, specific problems occur with internal financing. The provision of financial resources from the enterprise itself is difficult for young enterprises, as the possibilities of generating owned capital from the turnover process normally do not exist or are too small [Shane (2003)]. The start-up phase is characterized by the fact that at the start no income is made from sales while start-up losses occur. Consequently, no profits are available for self-financing in this phase. Profit accumulations as a possible way to internal financing have only a positive effect in the medium-term, as reflected in the balance sheet of the young enterprise. The financial balancing entries of the depreciations, which flow back into the enterprise from sales income, have also only a noticeable effect over a medium- to long-term time-horizon. At the same time, a justification for amortizations from the point of view of business management lies in the fact that the goods of the fixed assets are subjected to regular value depreciation and have therefore to be renewed, mostly through replacement investments after their useful life has expired. A sale of fixed assets as a source for internal financing can normally not be considered at the start. In addition, financings through payout reductions up to the availment of reserves are not really a feasible financing alternative for young enterprises, as the financing effect (if available at all) only becomes effective medium- to long-term.

As internal financing is barely possible for young enterprises because of the described reasons, the classification according to the capital origin into internal and external financing does not seem suitable in our context. Therefore, the classification is made into owned, borrowed and mezzanine capital.

In the systematization according to the legal position of the capital providers, one distinguishes between creditor rights (borrowers) and owner rights (shareholders). The focus lies therefore on the financing function in its real sense. Owned capital becomes fundamentally necessary for founding an enterprise and, in addition, is required for the formation of specific development processes, i.e., of the growth processes of a young enterprise. This means that owned capital is placed at the open-ended disposal of the enterprise. In contrast, medium- to long-term debt is mostly given with a time-limit and bound to a defined purpose, as it is, for instance, the case with working capital credits or investment credits (e.g., provided by banks). The feed-in of owned capital through investments of the enterprise owners is, therefore, one of the most frequent forms of financing within the entrepreneurship context. If adequate collateral customary in banking (e.g., real estate or other marketable assets) is available, various forms of borrowed capital can be a financing alternative for young enterprises. Mezzanine financing is less important for early-phase start-ups than for young enterprises in the growth phase or for established enterprises under the condition of stable revenue expectations.

## 6.2 Models of Start-up and Growth Financing

Specific models of start-up and growth financing have so far mainly been discussed in American entrepreneurship literature. They are primarily **low-budget-models** (e.g., self-feeding and bootstrap approaches) as well as the **big-money-model**, which forms the basis for the financing of innovative or fast growing enterprises with a high capital demand [see, for example, Bhidé (1999); Nathusius (2001); Kuckertz, 2006]. The different financing models are primarily the result of the different business models, the expected market opportunities and the financial resources which are available to the founders for the build-up of their enterprise. In addition, these models distinguish themselves in their respective strategic orientation as well as in the underlying leadership culture. Different financial tools can be assigned to the specific models and approaches, which are typical for the financing of the establishment and growth phase of the enterprise.

Decisions regarding the financing have both a strategic and an operational dimension which can have an influence on all areas of the enterprise and, in an extreme case, on the existence of the enterprise itself. This applies in particular to new and young enterprises which, due to their generally still low equity basis, are very prone to failure. Against this background, financing decisions have to be taken with great care, especially under strategic aspects. At the same time, financing and enterprise strategies influence each other mutually. [For example, Westhead and Storey (1997) found that the prior acquisition of external capital influences future employment and production capacity in UK high technology firms.]

Within this context, we can distinguish between two strategic approaches of start-up and growth enterprises [Nathusius (2001)]:

- Strategy follows finance and
- Finance follows strategy.

In the first approach, **strategy follows finance**, *financing* represents *the limiting factor for strategy.* The realization of the strategy of a founder team is limited by the financing possibilities, and the financing conditions thus form the crucial bottleneck in entrepreneurial strategy development and its realization. [See Grünhagen (2008) for empirical case studies on the unfolding of financing and start-up processes in new enterprises in Germany.]

In the approach of **finance follows strategy,** the *financing is not really a limiting factor.* This approach is adopted by newly founded and young enterprises whose business models and strategies are so convincing that they seem attractive for financially strong investors.

### 6.2.1 Low-Budget-Models

In the case of **low-budget-models,** financing alternatives are only available to the founders to a limited extent. Important forms of these models are the **self-feeding-approach** *within the meaning of personal self-financing* and the **bootstrap-approach.** In the self-financing approach, the founders must rely primarily on their possibilities of *self-financing and the employment of their own labour. Taking-up borrowed capital is usually not an alternative*, because no or insufficient securities, as they are customarily required in the context of bank loans, are available. The unpaid work performance of the founders and the self-financed fixed assets, such as own vehicles or computers, often form the essential basis for starting the enterprise. The values created by the “sweat” of the founders are also called “sweat equity” in American business literature. Typical examples are new enterprises which started in the cellar or the garage of the family and have developed step-by-step.

Closely connected with the self-financing approach is the **bootstrap-approach**, which gives an enlarged financing scope to the founder enterprise. Literally, the American word *"bootstrap"* means bootlace. Accordingly, in a figurative sense, the bootstrap-approach refers to a closely laid-down strategy procedure for the formation and development of an enterprise whose main characteristic is the low availability of financial resources. Typical financing tools which are considered within the framework of the bootstrap approach are the equity capital of the founders, the capital owned by families and friends, public development programmes in the form of own and debt capital, bank and supplier credits as well as leasing financing [Bhidé (1999); Winborg/Landstroem (2000); Neeley (2004)].

Within both the self-financing approach and the bootstrap-approach, two development tendencies are possible, either "to start small and remain small" or "to start small and grow" [cf. Jenkins/Johnson (1997)]. Entrepreneurs who followed the bootstrap approach, i.e., who started as small enterprises, grew and today take the position of important global enterprises, are, for example, the founders of *Microsoft*, *Dell* and *SAP.*

### 6.2.2 Big-Money-Model

A sound business model, a promising entrepreneurial opportunity as well as a convincing business plan form the basis for the realization of the **big-money-model.** As a rule, it is young enterprises which, *because of their expected strong and dynamic growth, have a high capital requirement.* The development approach in this model type is *"to start big and to grow".* Potential investors, who are also in a position to meet the high capital demand, are primarily business angels and venture capital companies. Further financing possibilities are mezzanine financing, private placements and, in a later phase, possibly an initial public offering (IPO) as the first issue of the company's shares at the stock exchange.

Enterprises following the big-money-model are often research- and capital-intensive, with the typical business-line-spectrum ranging from information and biotechnology through to medical technology and nano-technology. Examples of enterprises which used the big-money-model as the basis for the financing of their growth are *Intel*, *Apple*, *Genentech* and *Qiagen.*

### 6.2.3 Importance of the Financing Models in Practice

The outlined models and approaches are idealized, i.e., in practice overlapping may occur, for instance, in the self-financing and bootstrap approaches. In addition, fluid transitions between the models may form in the course of time. It is, for example, possible that an enterprise is founded on the basis of the self-financing principle, operates after some time on profit generating equity capital and, following the bootstrap-approach, can obtain further own or outside resources for financing its growth. *Dell* and *SAP* have, for instance, shown that even the transition from the bootstrap-approach to the big-money-model is in principle possible during the growth of an enterprise.

For example, according to estimates, approximately 85 to 90 percent of new enterprises in Germany start off small according to the low-budget-model and remain small. Approximately 8 to 12 percent of the enterprises start small and grow. Only 1 to 2 percent of enterprises follow the big-money model, i.e., enterprises such as technology enterprises that start big and continue to grow dynamically. [See Nathusius (2001); also cf. Stouder/Kirchhoff (2004) for evidence on founders' initial financing choices from the large scale US Panel Study of Entrepreneurial Dynamics.] Table 6-3 gives a survey of the individual models.

***Table 6-3:*** *Survey of low-budget and big-money models*

| Model | Criterion | Development Approach | Forms |
|---|---|---|---|
| **Low-budget model**<br><br>**Strategy follows finance** | – Influence of the financing process on enterprise strategy | – Variant 1: "to start small and to remain small"<br>– frequency of occurrence: 85-90%<br><br>– Variant 2: "to start small and to grow"<br>– frequency of occurrence: 8-12%* | – Self-feeding approach<br>– Bootstrap-approach |
| **Big-money model**<br><br>**Finance follows strategy** | – Influence of the financing process on enterprise strategy | – "to start big and to grow"<br>– frequency of occurrence: 1-2%* | – Private investors<br>– Business Angels<br>– Venture capital<br>– Private placements |

* in Germany according to estimates

Not only Germany, but also other European countries are lacking in suitable empirical investigations which would allow a reliable assessment of the practical relevance of the models and approaches. One could, for instance, assume that perhaps women with young children would prefer small enterprises with low initial growth aspirations, which at first remain small. In contrast, a well-trained founder team, for example, from the sector of biotechnology, chemistry and business management, would prefer to found an enterprise oriented towards growth following the big-money-model. However, so far there is limited empirical evidence for the listed estimates and suppositions, in particular for different types of entrepreneurs.

### 6.2.4 Typical Financing Phases

From its start-up to its liquidation, an enterprise runs through various phases which may have time horizons of different length. The individual phases are different for each individual enterprise and depend on the relevant internal and external factors of influence [see also chapter 7.1.3.1]. In the individual phases, different financing sources are also available to the enterprises. Typical sources, which a newly founded enterprise takes advantage of in the first financing phases, are private investors, which are also called the **4Fs** in English-language areas [Bygrave (1997)]. These are, in detail

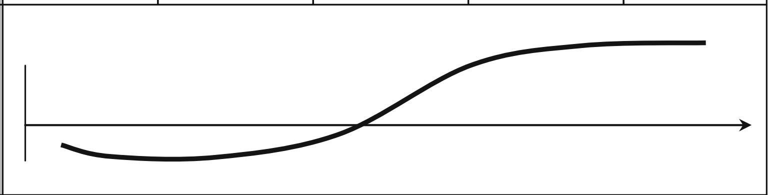
- **F**ounders (with their personal savings),
- **F**amily,
- **F**riends,
- **F**oolhardy investors.

Under the designation of *foolhardy investors* come mainly private investors and business angels. Various countries have public enterprise policy programmes tailored to support new ventures. These programmes may offer further possibilities to entrepreneurs for acquiring both equity and debt funding from public sources. To name two typical examples, in Germany there are special equity programmes which aim to strengthen the typically weak equity base of small, medium and young enterprises; as far as debt financing is concerned, the UK offers a small firms loan guarantee scheme to alleviate entrepreneurs' problems to provide adequate collateral to obtain commercial bank loans. Because of the specific characteristics and uniqueness of each enterprise formation, it must be taken into account that Illustration 6-2 shows an ideal-type development [according to Gompers/Lerner (1999); Timmons/Spinelli (2004); Schefczyk (2000) and Schefczyk/Pankotsch (2003); also cf. Bhide (2000)].

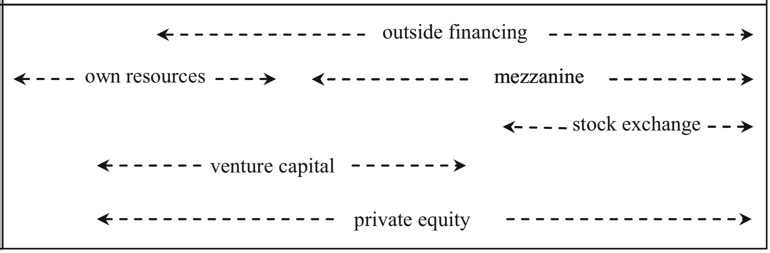
***Illustration 6-2:*** *Forms of financing in the enterprise development*

| ***financing phases*** | ***early stage*** | | ***expansion stage*** | ***late stage*** | |
|---|---|---|---|---|---|
| | seed | start-up | expansion | bridge | mbo/mbi |
| ***typical enterprise activities*** | ▪ product concept<br>▪ market analysis<br>▪ enterprise conception | ▪ enterprise foundation<br>▪ product development<br>▪ marketing concept | ▪ start of production<br>▪ market entry<br>▪ growth financing | preparation of:<br>▪ going public or<br>▪ sale to traditional investor | ▪ take-over by existing or external management |

***profit development***



***typical financing sources***




**Seed-Phase (Early Stage)**

Founding a new enterprise requires careful and detailed preparation. As a first step, the basic feasibility should be examined (feasibility study). If the entrepreneurial opportunity and the business model are promising, a business plan is prepared as the next step [typical other pre-cursor activities in the emergence phase prior to founding are discussed in Carter et al. (1996)]. This phase is typically carried through with the own resources of the founders as well as with the financial means of family and friends. A further possibility consists in taking advantage of public subsidies. Business angels too already invest selectively during this phase. Amongst venture capital companies, however, only a very small number make seed capital available as the risks and the possibility of a total loss in this phase are still decidedly high.

**Start-Up Phase (Early Stage)**
In the start-up phase the actual formation of the enterprise takes place. The amount of the financial requirement varies according to the growth prospects and the business line in question. Equity financing through founders, family and friends, business angels and venture capital companies can be considered by innovative or strong-growing enterprises as alternative sources of funds. The possibility of credit financing through a bank generally depends in this phase on whether the founders can provide securities. As the risk-return ratio is still difficult to assess, mezzanine capital is normally not employed in the early-seed and start-up stages of the enterprise, with an exception being perhaps the shareholder's or partner's loan (which, as a form of mezzanine capital, can already be important in this phase of enterprise development).

**Expansion Phase (Expansion Stage)**
Particularly for fast-growing and innovative young enterprises, there are many and diverse financing alternatives available for the expansion phase. Venture capital or strategic investors are, for example, available as financing sources. If a positive cash flow is generated, also borrowed capital, e.g., in the form of bank credits, can be considered in this phase. A typical condition for making substantial use of loans is that either sufficient collateral is available in the eyes of bankers or interest and redemption payments can be made from the cash flows of the enterprise. In the case of a moderate growth of the young enterprise and a stable positive profit situation, mezzanine instruments can also be relevant.

**Bridge, MBO/MBI (Late Stage)**
Beyond early stage establishment and growth, financing phases also occur in the more advanced development of a young enterprise which, although mentioned here, will not be discussed in detail [for an overview of different types of buy-outs and their characteristics see, e.g., Wright et al. (2001)]. These financing phases are:

- Bridge phase (Preparation for going on the stock exchange)
- Management buy-out (MBO) (Take-over of an enterprise through internal management)
- Management buy-in (MBI) (Take-over of an enterprise through external management)
- Turn-around phase (Reorganization and new start for the enterprise)

# 6.3 Equity Financing

## 6.3.1 Concept and Forms of Equity Financing

The concept of equity financing generally comprises the allocation and increase of equity capital through the owners or founders of the enterprise or through retaining profits which have been generated in the enterprise. Equity financing as internal financing occurs, as already explained, through open or silent **self-financing** (profits, reserves, depreciations, regrouping of assets). As self-financing can seldom be considered by young enterprises, it will not be discussed further within the following explanations. In the case of external equity financing, the capital is brought in through **capital contributions** (of owners) or through **shareholdings** (of shareholders). The classical form of equity capital financing is direct financing; its form depends on the legal form of the new enterprise. Capital contributions can be made through **contributions in cash** in the form of financial resources or through **contributions in kind** in the form of assets. The assets will, for instance, refer to machines, real estate, vehicles or rights (e.g., patents, licences).

***Illustration 6-3:*** *Developments of equity*

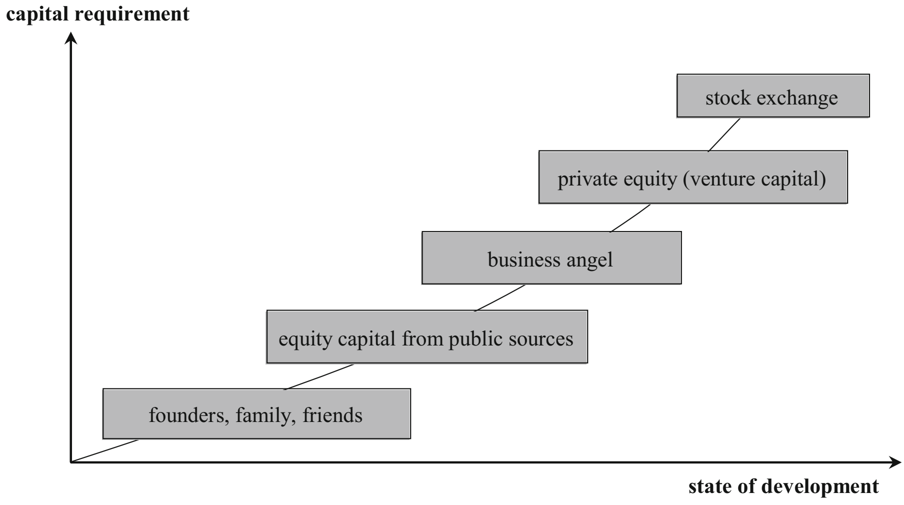



Illustration 6-3 shows in an ideal-type case how the volume of (equity) capital requirements depends on the development stage of the new enterprise. In addition to informal own resources of founders, family and friends as well as public programmes to support the equity base of new enterprises, other equity sources become increasingly important with the growing enterprise, such as, for example, business angels, venture capital companies or also participations by employees (e.g., through employee stock option schemes). [For an overview of equity financing sources see Timmons/Spinelli (2004).]

### 6.3.2 Equity Financing: Founders, Family and Friends

The usually first and most important source of equity is provided by the founders themselves [Shane (2003)]. This contribution to the overall capital of the enterprise is mostly informal capital which can be fed-in through contributions in cash or contributions in-kind. The evaluation of the contributions in-kind, as, for example, in the form of vehicles or machines, is often problematic. Here the relevant legal valuation regulations should be observed.

By bringing-in equity capital, the founders show that they are prepared to take a personal financial risk. The personal financial commitment of the founders in the form of equity is important for other potential capital providers. In particular, this commitment has an important **signalling function** in face of imperfect information about the quality of the founders' venture projects [e.g., Heitzer (2000); Kreps/Wilson (1982)]. The enterprise founders document that they are convinced by the economic feasibility of their business model.

Family members and friends are persons with whom the founders are often very close and have a special relationship of trust. To use these persons as financiers is therefore a natural progression and in fact a typical form of initial equity funding of new businesses [Stouder/Kirchhoff (2004)]. The resource inflow can be organized in many and diverse ways and often there will be no formal agreements regarding dividends and other terms and conditions [Shulman (1997)]. Apart from donations, where the tax aspects are especially in the foreground, the finances can be brought in as dormant partnerships. In the case of a loan being made through relatives and friends, it is necessary to negotiate contractual agreements about methods of paying interest and making repayments; however, this is often neglected for this form of “friendly money” (ibid.). In this way, family members or friends can become corporate members or creditors of the enterprise. The advantage of the close relationship by financing through family and friends is opposed by a significant disadvantage, as tensions can develop between the participants, which, in an extreme case, may lead to a threat for the organization or the development of the enterprise. For this reason, these sources of financing should be examined in detail, and their advantages and disadvantages must be weighed carefully against other alternatives.

The resources of the founders, family members and friends are, however, not sufficient for most innovative and fast-growing new enterprises in order to meet their high financing requirements [Brettel (2005)]. Such enterprises normally require further financing resources.

## 6.3.3 Equity Financing: Business Angels

### 6.3.3.1 Concept and Characteristics of a Business Angel

**Business angels** are "high net worth individuals who invest their personal capital in a small set of companies" [Denis (2004), p. 307]. They are private investors who, metaphorically speaking, have a know-how wing and a capital wing at their disposal [Günther (2005)]. For a true characterization it is important that both wings are present, although one business angel may provide more capital than another and others may make more know-how and experience available [Kleinhückelskoten (2002); Coveney/Moore (1998)]. In cases in which only one wing is present, we are dealing, for example, with a consultant (know-how) or financial investor (capital), but not a business angel.

Business angels *risk part of their private money by investing directly* in enterprises without institutional intermediaries bridging between them and the new enterprises they invest in. These investments are equity capital for which basically no repayment obligation exists [Benjamin/Margulis (2000)]. Business angels are in most cases *active or formerly successful entrepreneurs or executive employees* who, because of their professional activity, have a *high degree of experience*, far-reaching *contacts* and a *considerable private fortune* at their disposal. With their capital, know-how and contacts they support through their investments a starting-up, established or growing young enterprise [Fenn et al. (1997)]. Their motivation lies primarily in achieving a return adequate to the risk, but also in the pleasure of the activity and in the challenge of supporting a young enterprise; i.e., business angels may follow both financial and non-financial aims, in particular hedonistic and altruistic investment motives [Brettel (2004); Sullivan/Miller (1996)]. A business angel does, however, not take on operational management tasks. The enterprise is led by the founders, and the business angel only supports the management. In this way, a relationship of trust is created between entrepreneurs and business angels, which is of fundamental importance for the success of the enterprise.

Business angels are financially independent, mostly male and around fifty years old [also cf., for example, earlier studies by Brettel (2004) for Germany and Mason/Harrison (1996) for the UK]. They are, as a rule, former entrepreneurs or managers who bring capital as well as specific knowledge and experience into the enterprise. In addition, they may also provide the young enterprise with network contacts. Through their coaching, financial commitment and negotiation of network contacts, they contribute to the build-up and further development of young enterprises. With the financial resources from their private property they finance directly the seed- or start-up phase of an enterprise. Moreover, numerous business angels also invest in turnaround enterprises.

Historically speaking, the relevant literature charters the origin and development of business angel financing in the USA. Five business angels supported Henry Ford in the build-up of his automobile enterprise back in 1903. In 1977, business angels invested in *Apple Computer* and in 1978, business angels initiated the expansion of *Body Shop*. [Van Osnabrugge/Robinson (2000)] Many of today's global enterprises such as *Microsoft, Dell* and *Intel,* were financed by business angels in their early development phases. For example, in Germany too, there were prosperous industrialists at the beginning of the 20th century who made financial resources available for the build-up of enterprises, without actually being called business angels. Werner von Siemens, for example, counted amongst the first financiers of the *Brüder Mannesmann* [Tschammer-Osten (1996)].

Typical characteristics of business angels in Europe (e.g. in the UK and Germany) are summarized below [see NESTA (2009) for the UK and Volkmann/Tokarski/Günther (2006) for the German case; see also EBAN (2009)]:

- Typically more than 90% of business angels are male and between 45 and 55 of age.
- Business angels often command a substantial degree of prior management and entrepreneurial experience. In particular, the latter tends to make angel investments more successful, especially in terms of early-stage angel investments [NESTA (2009)].
- The number of investments made per year varies, often ranging between four to six; this may be because of the limited time and management resources of individual angel investors as compared to larger institutional investors.
- The average investment volume is lower as compared to institutional venture capital investors, typically ranging between 100.000 and 500.000 Euro (also see the discussion below). Note that investment volumes may vary considerably with many smaller investments and only few large-scale investment projects. [About 90% of the investments of UK business angels were made for less than 100.000 GBP; NESTA (2009]
- A recent trend shows that investment projects of business angel networks and individual angels are increasingly undertaken in collaboration with other types of investors. [EBAN (2009) indicates that co-operation projects with seed or early-stage venture capital funds or family offices continue to increase, supposedly because the widening equity gap of new enterprises necessitates collaboration on the side of investors. For individual angels in the UK, NESTA (2009) reports that today more than 80% of investments made are with other co-investors.]

Business angels normally invest in the early life-cycle phases and with lower financing volumes than venture capitalists or strategic investors [EBAN, 2009)]. The investment volume of German business angels lies between 25.000 and 500.000 Euro, whilst venture capital companies only invest in young enterprises from the sum of 250.000 Euro upwards. A recent study on active business angels in the UK indicated an average investment volume of 42.000 GBP per deal with a median annual investment of 220.000 GBP per investor [NESTA (2009)]. As far as changes during the 2008 financial crisis are concerned, the 2009 compendium of the European Trade Association for

Business Angels, Seed Funds, and other Early Stage Market Players (EBAN), which accumulates data from business angel networks across Europe, reports that the average investment size has increased slightly in 2008; this may be mainly on account of increasing follow-up investments of business angels in their portfolio companies which lack alternative sources of funding during the crisis. The field of activity of the business angel usually lies on the regional level. For example, about 30% of UK business angels invest within 40 miles from their home [NESTA (2009)]. For European business angel networks EBAN (2009) reports that the current number of investments made outside the home region or country of networks has decreased; possibly, the financial crisis may have shifted the focus further towards local deal flow and back-up investments. Business angels are usually remunerated for their commitment to the enterprise in the form of company shares. The hold-time of these company shares varies, depending on the motives and objectives, and is usually three to seven years. Finally, it should be noted that the overall size of national business angel markets is considerably smaller than in North America. The per capita angel investment volume in the USA is more than 3.5 times the UK volume, which is Europe's biggest national angel capital market [NESTA (2009)].

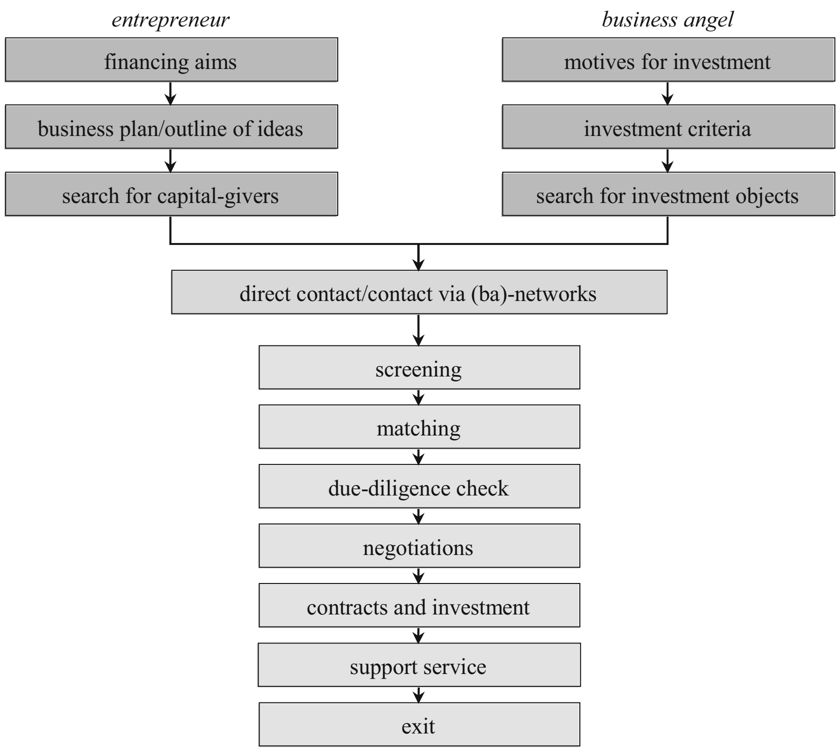
The **equity capital market for business angels is informal.** The meeting between a young enterprise and a business angel occurs via *personal, informal contacts.* However, today many business angels are also organized in regional or super-regional networks, which have been appearing in increasing numbers during the last few years, not only in the USA but also in Europe. These networks provide support in many ways, both for the supply and the demand side, e.g., by making available relevant data and information as well as in screening and matching processes.

### 6.3.3.2 Equity Investment Process of Business Angels

Contacts with business angels who are not organized in networks usually happen accidentally or through a personal approach or relation. Simpler and less dependent on direct contact is the utilization of business angel networks. [At the Pan-European level, entrepreneurs may start to search for business angels as well as other seed and early stage funding at www.eban.org; note that in European countries there are both regional business angel networks as well as meta-networks at the national level.]

The following Illustration 6-4 shows the ideal development of the screening and investment process of a business angel.

***Illustration 6-4:*** *Investment process of a business angel*




The investment process, including making contact via a business angel network, will now be discussed briefly. Many business angel networks have developed various procedures with which to bring together interested enterprises and business angels. [Broadly speaking, these process elements or steps are, however, fairly similar across different angel networks, and, as an example, we follow the procedure applied by BAAR, which is a regional business angel agency in the Ruhr area in Germany; www.baar-ev.de] The enterprises typically undergo a prepared screening and matching process before the first consolidating conversation with an interested business angel takes place. This **screening** process comprises the selection and evaluation of business plans which are submitted by capital-seeking enterprises. In some cases, the submission of an outline of ideas suffices for a first examination. For the example of BAAR, capital-seeking entrepreneurs make their application and outline their business idea, product or service, growth potential as well as capital requirement and give a survey of their team. [This and the further matching process will, however, be fairly similar also in other business angel networks in Germany and other countries.] In addition, the executive summary of their business plan must be sent to the network, which guarantees confidentiality. The received documents are sifted through and examined by the BAAR. Then the entrepreneurs are informed about the result of the examination. This selection process of screening is in practice often carried out within the network by a committee of business angels and other cooperating persons who have at their disposal an extensive experience in the evaluation of business plans.

Those enterprises which have passed the screening process successfully are invited to a so-called **matching** event. This matching event, in which approximately six to ten enterprises take part, is generally known as group-matching in contrast to single-matching and internet-matching. The matching event, which takes place regularly (e.g., monthly), is designed to facilitate the first personal contact between the selected enterprises and the business angels. At this occasion, the entrepreneurs are given the opportunity of presenting their business idea within a fixed preset timeframe (e.g., ten minutes). It is possible that the entrepreneurs may already demand a non-disclosure agreement at this stage. The cooperation of the networks normally ends with the matching event.

In the example of BAAR, entrepreneurs who have passed the screening process with a positive result will be asked to complete a so-called *one-pager* and to sign a non-disclosure statement. The **one pager** is a document in which *the core data of the enterprise,* the *business-line,* the *business concept in one sentence,* the *product* and *its usefulness to the customer,* the *technology or unique selling propositions and patents, market information,* the founder/*management team, success to date, status and additional information* are to be listed briefly. Finally, the *financing concept* (origin and utilization of capital resources), as well as some *financial data* such as the *turnover, EBIT* (earnings before interest and taxes*),* the *number of employees,* and the *investment and capital requirements* for the next five years are to be included. If everything fits, the entrepreneurs are invited to present the enterprise to a circle of BAAR members. If the entrepreneur is not given the opportunity of a direct presentation, BAAR establishes contact with business-angel networks in other regions or with cooperation partners within the new business community.

The conversations, the **due-diligence** process and further negotiations then continue bilaterally between the business angel and the enterprise. Generally, both the investment-screening process and later contracts are less elaborate and formal than in the case of institutional venture capital investors [Mason/Stark (2002); Brettel (2005); however, also note that doing a proper due diligence may enhance the investment return of business angels, NESTA (2009)]. If there is a mutual interest between the business angel and the entrepreneur, a further step with a more in-depth conversation may occur, followed by a due-diligence process carried out by the business angel. (The due-diligence process comprises a careful examination of the enterprise and forms an essential basis for determining the enterprise value, e.g., financial, market, technology, and legal due diligence).

If the enterprise in question is in the pre-founding or founding phase, the detailed due-diligence examination normally concentrates on the **business plan** as well as on the **founder team** and its specific (technical, commercial and entrepreneurial) competences; *the founder team is at the forefront* as it is one of the most important criteria for a business angel when deciding whether an investment is to be carried out or not [Mason/Stark (2002)]. This focus of business angels on the founders may have several reasons, for example, business angels' hedonistic objective to work closely with the founders and establish a growing business or the less elaborate contracting to address opportunism problems in informal business angel relationships [Van Osnabrugge/Robinson (2000)]. Moreover, the influence of the founder team on the entrepreneurial level of performance has been investigated by Ensley (1999), who considered the founder team to be one of the most important determinants of new venture performance.

As regards the business plan and its managerial assumptions, business angels pay special attention to the strategic, financial and technical chances and risks of the new venture project. In principle, the expected economic feasibility of the business model is the focus of attention. In addition, aspects such as special product advantages over competitors and the estimated market and customer potential of the enterprise are of importance. In individual cases, business angels include experts in the examination, for example, when special know-how of a certain technology is required in connection with the start-up concept. As regards financial planning, the plausibility and transparency of the turnover, profit and liquidity planning as well as the capital requirement planning are of particular interest. Typical mistakes of enterprise founders in this context are that the sales revenues are planned too optimistically, that prices are too high, and that costs and corresponding capital requirements are estimated too low. A realistic planning is certainly important to achieve credibility and gain the trust of the interested business angel. Furthermore, possible industrial protection rights of the young enterprise may be significant, be it in the form of patents, brand names etc. Data referring to these non-material values must not be lacking in the business plan and will be examined in detail by the business angel. Of special interest to the business angel in the start-up phase and beyond, are any pre-signed contracts of the enterprise, such as, for example, manager contracts and company contracts, contracts with other investors or cooperation agreements (e.g., with technology partners).

If a young enterprise has already been operative for a few years, additional documents will be required within the framework of the due-diligence process. The first annual balance sheets, for example, give an insight into the revenue situation, the sustainable value of the fixed and liquid assets as well as the situation with regard to the capital structure and the level of gearing of the enterprise. By quoting client testimonials the enterprise shows that it has already achieved success in the market [cf. Reuber/Fischer (2005) for the rationale and potential of reputation signalling through customers in the context of new enterprises]. In this phase, the reputation and image of the young enterprise can already play a role in its assessment.

The results of the due-diligence process form the basis for the negotiations of the enterprise with the business angel about the enterprise value. The negotiations often turn out to be complex and time-intensive. When both parties have reconciled their conflicting interests and achieved agreement as regards the value of the enterprise, negotiations about the sum or quota to be contributed by the business angel will follow. After the positive completion of the negotiations, concrete contracts will be drawn up, with rights and duties being laid down (for a limited liability company, for example, in the memorandum of association and management contract), as well as material aspects (e.g., appropriation and distribution of profits, salaries of managers). As a rule, it is also agreed in a contract which form the **exit** of the business angel shall take after approximately five to seven years (e.g., trade sale to other investors or repurchasing of shares by the enterprise founders). Going public as an exit strategy will probably only be considered in exceptional cases.

The negotiation, contract and exit phases for business angels and venture capital companies are similar. There is, however, a difference with regard to the **support service** for the financial projects. Normally the service will be essentially more developed and intensive with business angels than with venture capital companies. As already described, business angels place at the disposal of the enterprises not only their financial resources but also their experience and know-how. This means that business angels can only look after a few investment projects simultaneously, so that their number of projects is usually significantly lower compared with venture capital companies. [For the usefulness of business angels and venture capital companies as different sources of external equity funding available to entrepreneurs see, for instance, Bell (1999).]

## 6.3.4 Equity Financing: Venture Capital Companies

### 6.3.4.1 Concept and Significance of Venture Capital

The origin of venture capital financing lies in the United States. According to Bygrave and Timmons, the first venture capital company, the American Research and Development Corporation (ARD), was founded in the USA in 1946 [Bygrave/Timmons (1992)], and, not surprisingly, the most elaborated and differentiated venture capital market has emerged in the United States [Jeng/Wells, 1999]. Furthermore, international empirical evidence suggests that the venture capital markets that developed later in other countries have adopted US methods with regard to the management of venture funds and investment screening practices; overall this led to a high degree of homogeneity in venture capital practices across countries [Zacharakis (2004); for the development of venture capital as a market segment in Europe see Manigart (1994)]. The significance of venture capital for high-growth new enterprises is indicated by Shane (2003) who estimates that VC companies are jointly responsible for about one-third of all initial public offerings in the US, while investing in merely one percent of all start-ups.

In contrast to debt or borrowed capital, **venture capital** is *equity capital.* These equity or equity-similar resources are open to the full range of entrepreneurial opportunities and risks. Venture capital is placed by the venture capitalist ("VC provider") at the disposal of the enterprise ("VC taker"; portfolio company) without pledging collateral and over a long term, often three to seven years. Unlike lenders, the venture capital investor is not a creditor, but will rather be a *shareholder of the enterprise*, who is liable with his contribution to the capital stock of the business. Even though venture capital refers to risk capital, venture capital investors do not only participate in the risks, but also in the opportunities of a young enterprise, in particular in the form of participating in increases in the enterprise's value when selling their investments in the future. Correspondingly, there is *no obligation of repayment for the entrepreneur.* Venture capitalists usually do *not* demand for a *fixed yearly interest claim*, and their capital contribution is lost in the case of insolvency. In certain cases, the venture capital companies also provide management consultation and support, which is sometimes called "smart money". In **difference to outside (debt) financing,** venture capital companies will have *information and controlling rights as well as a voice in the management* of the enterprise they invest in [Gompers/Lerner (2003)]. As a rule, however, venture capitalists do not necessarily aim at obtaining the role of a majority partner, and in established enterprises minority partnerships are also entered into. [For basic principles of venture capital investments in entrepreneurial new ventures see also Gompers/Lerner (1999) or Schefczyk (2006).]

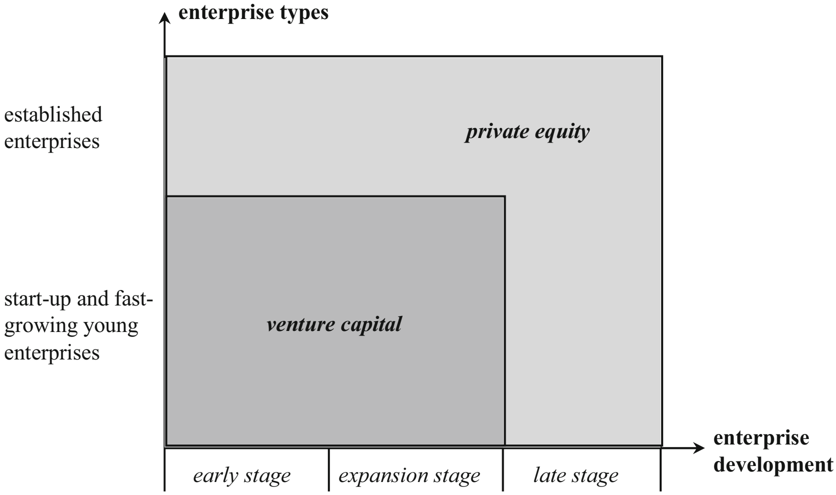
**Relationship between Private Equity and Venture Capital**

In principle, there are various different definitions of the Anglo-American concept of private equity. According to the definition of the European Venture Capital and Private Equity Association (EVCA), **private equity** is *equity capital made available to enterprises which are not listed on the stock exchange.* Private equity is seen as a generic term for the total market of private equity capital. Private equity can be employed for financing various occasions, e.g., for the development of new products and technologies, increases in working capital, the carrying out of acquisitions or the improvement of the balance sheet structure of an enterprise. In addition, it can be used to resolve shareholder and management problems. Examples would be the solution to the problem of management succession in family-led enterprises, a management buy-out or management buy-in. **Venture capital** is a sub-sector of private equity, a form of equity financing through investments in stock capital in an enterprise's early-stage phase (seed- and start-up phase) as well as in the later expansion phase. As an important sector of the private equity market, venture capital is primarily employed for financing young, technology-oriented enterprises [EVCA (2006)].

However, both concepts of private equity and venture capital are often mixed up or used in different ways in the European context. Thus the concept of venture capital is in many cases also used within the framework of financing management buy-outs or management buy-ins in already established enterprises and extends therefore to all phases of enterprise development, including the later stage, although, strictly speaking, we are dealing with private equity and not venture capital financing according to the definitions or the EVCA.

Illustration 6-5 is designed to show the relationship between the concepts of private equity and venture capital.

***Illustration 6-5:*** *Relationship between private equity and venture capital*




In the context of enterprise succession, the private equity market gains particular importance. This is apparent in a study of the *EVCA* carried out by *the Centre for Management Buy-out Research* (CMBOR). The evaluations are based on 117 completed questionnaires which were returned from a postal interviewing of 1,645 European enterprises, formerly led by families, which had carried out a buy-out supported by private equity during the period 1994-2003. The evaluation led to the result that private equity is an essential instrument in managing the succession of European small and medium-sized enterprises. Without private equity, a succession would have failed in many cases and a large number of enterprises would not have been able to continue as independent businesses [EVCA/CMBOR (2005)].

### 6.3.4.2 Structure of Venture Capital Companies

**Venture Capital (VC) companies** usually invest in small and medium enterprises at various occasions for financing. While these enterprises are not listed on the stock exchange, they are innovative and have a high growth potential [Wright/Robbie

(1998)]. Venture capital companies are often distinguished according to whether they are assigned to the public or to the private sector and whether their business purpose is oriented more towards development or towards achieving returns. The principal objective of VC companies is to generate above-average returns for their investors as compared with other forms of investments. The returns for the venture capitalist result from the possibly increased enterprise value and depend on his/her stake in the enterprise as well as on the contractual agreements that have been made.

Venture capital companies can be differentiated according to various criteria [for example, cf. Manigart (1994)], e.g.,

- The business purpose (development vs. return orientation)
- The type of capital provider (public, private)
- The company form
- The target group (business sector, regions, different phases of enterprise development)

Venture capital companies are financial intermediaries collecting financial resources from investors and investing them in enterprises. The venture capital market, in contrast to the informal business angel segment, is thus part of the formal institutional equity market. Table 6-4 illustrates the essential differences between the informal and the formal equity market [according to Engelmann et al. (2000) and Brettel/Rudolf/Witt (2005); see also Wright/Robbie (1998).]

**Table 6-4:** *Informal and formal equity capital market*

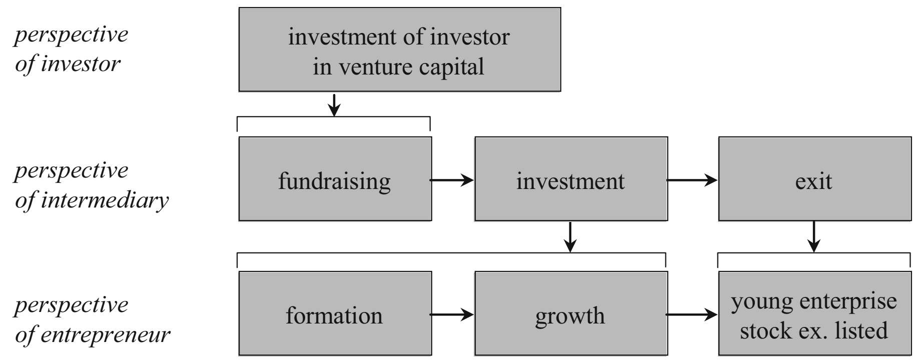
| Characteristics | Informal Equity Market | Formal Equity Market |
|---|---|---|
| **Investment according to enterprise phases** | Early stage | Early stage, expansion stage, late stage |
| **Financing volumes** | Up to 0.5 million € | Over 0.5 million € |
| **Geographic reach** | Mostly regional limitation | Mostly no limitation |
| **Motives** | Financial and non-financial motives | Purely monetary motives |
| **Information rights** | Low formalization | Formalized report system |
| **Controlling rights** | Less important | Very important |
| **Support** | Irregular | Regular, systematic |
| **Personnel resources** | Personal commitment of business angel | Venture capital partner, investment analysts |

The formal equity capital market follows primarily financial or monetary motives, and venture capital companies are professional players in this market. Venture capital companies supervise and manage a VC fund, from which capital investments in young enterprises are made. In addition to the management and administration of its funds, a VC company is also responsible for attracting investors and raising sufficient capital for its funds from which investments in young enterprises are made. Investors are, for example, insurance companies, banks, pension funds or wealthy private investors.

When looking at the various levels of financial intermediation, one can distinguish between the *investor level* (the investors in the VC fund), the *intermediary level* (the VC company) as well as the *enterprise level* (the portfolio companies or the entrepreneur).

Illustration 6-6 shows the connection between the investor, intermediary and entrepreneurial levels [according to Achleitner (2001); see also Gompers/Lerner (1999) and Lockett et al. (2001)].

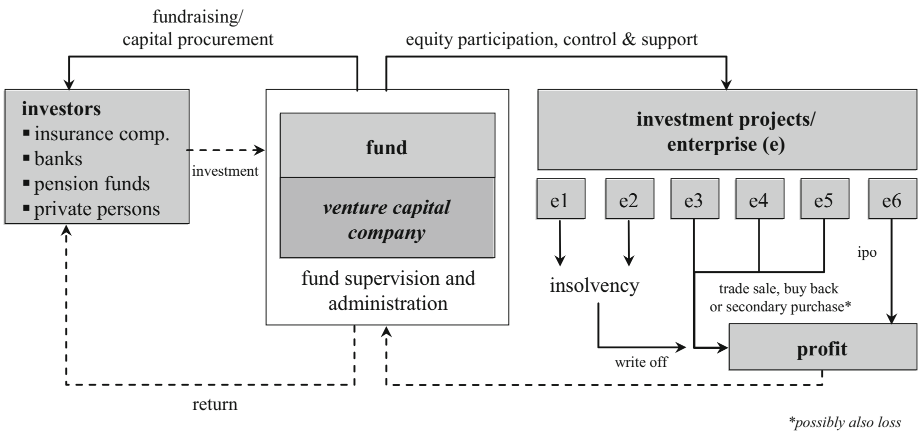
***Illustration 6-6:*** *Connections between investor, intermediary and enterprise (VC process)*




When initial fund-raising from investors has been completed, the VC company builds its portfolio by acquiring shares of enterprises from the fund. The VC company as an intermediary has a responsibility for the fund vis-à-vis the investors. Therefore, it will manage its portfolio investments, controlling and supporting the founders and management of the portfolio enterprises in order to increase the value of its investments. After the investment phase follows the exit of the VC company. There are various **possibilities for an exit**. In practical terms, it can be *going public* (initial public offering – IPO), *trade sale* (sale of shares to industrial strategic investors), *buy-back* (re-purchase of the shares by the enterprise's founder or management team) and *secondary purchase* (sale of shares to other institutional financial investors). All these exit options have the aim of generating a profit, a certain part of which will then benefit the VC company as well as the investors. In the case of a trade sale, buy-back or secondary purchase, it may even come to a sale below the value of the original investment. In this case, no profit is made. In addition, some young enterprises will also go into insolvency. In this case, the VC company must write off the investment.

Illustration 6-7 shows the organization and development of a venture capital business in a simplified form [according to Frommann (2005); also cf. Timmons/Spinelli (2004)].

***Illustration 6-7:*** *Structure of venture capital business*

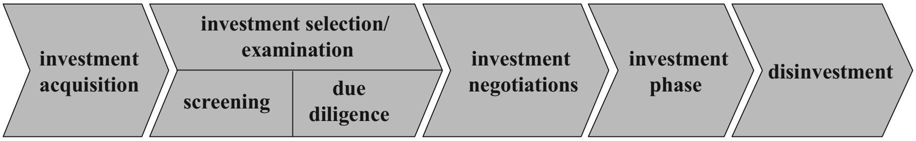



The structure is a simplified representation of the real conditions and gives only a survey of the venture capital business. The complete equity investment process is complex and time-consuming. For more information about the number and structure of venture capital companies as well as data of the venture capital market in Europe, see the website of the European Venture Capital and Private Equity Association [www.evca.com].

### 6.3.4.3 The Venture Capital Investment Process

Venture capital investments are characterized by a multi-step decision process of the VC company as shown in Illustration 6-8. [According to Schefczyk (2000); see also Feeney et al. (1999), Giudici/Paleari (2000) and Gompers/Lerner (2001).]

***Illustration 6-8:*** *Simplified venture capital investment process*




**Investment Acquisition**
First, venture capitalists try to gain knowledge about potential investment targets (deal origination). In concrete terms, this means to acquire information about capital-seeking enterprises which match the portfolio and investment strategy of the venture capitalists (in particular in terms of development stage of the venture, e.g., expansion stage, and industry focus; there are venture capital companies which only invest in specific sectors like information technology or biotechnology. In addition to the instrument of direct investments, possibilities of syndication can also be considered, i.e., carrying out the equity investment jointly with other venture capital companies [Lockett/Wright (2001)].

**Investment Selection and Examination**
Investment selection and examination is a complex and multi-step process which normally starts with a rough analysis (deal screening), followed by further more detailed steps [see Fried/Hisrich (1994)]. The screening is based primarily on enterprise-internal data, especially the business plan, which is an important source of information in particular for European VC companies [Manigart et al. (2000)]. From the entrepreneur's point of view, this initial screening constitutes a substantial hurdle. Rejection rates are considerable and Shepherd and Douglas (1999) conclude that often entrepreneurs will not get beyond contacting venture capitalists with their business plans. However, after a successful pre-examination to establish the feasibility of the business plan and the strategic fit with the fund's portfolio, a formal due-diligence analysis takes place (deal evaluation and due diligence). The enterprise is then examined against various criteria, such as, for example, surrounding market and industry conditions, financial situation, strategy, legal issues, organization, management and key personnel, marketing, and technology [also see chapter 7.4.4.2.2]. The VC company usually makes its selection of suitable investment offers according to its own invest-

ment criteria and principles. In addition, portfolio objectives are important when assessing potential commitments.

Essential criteria for the selection of potential investment targets are the anticipated profit on capital employed, the capabilities of the founder and management team, the enterprise's market potential and overall market attractiveness, the growth prospects of the market and the market share achievable for the enterprise, as well as possible product-related characteristics like unique selling propositions offering competitive advantage. [Empirical evidence of actual decision criteria of venture capitalists in Europe may be found in Muzyka et al. (1996), Manigart et al. (1997 and 2000) and Riquelme/Watson (2002).] This empirical evidence suggests that European venture capitalists focus particularly on the management and leadership qualities of the founders and here founder teams may have an advantage over individual entrepreneurs because of their team capabilities and competences.

**Investment Negotiations**
If, after the examination and selection of the investment opportunity, a positive decision has been reached, concrete negotiations about investing in the enterprise will take place (deal structuring). These negotiations usually begin with an investment proposal. Essential elements of the negotiations to follow are the terms and conditions regarding valuation (of the enterprise), investment volume, the possible share the VC company receives for its investment, as well as financial covenants such as information, co-determination and controlling rights. [For example, see Landström et al. (1998) for typical restrictive covenants in venture capital contracts.] Contingent upon reaching a successful agreement on the above conditions, a final investment contract between the venture capitalist and the enterprise will be signed.

The essential basis for the price negotiation between the two parties is the value of the enterprise. The evaluation of young enterprises is, however, a difficult process and in practice VC companies use different, sometimes pragmatic and approximate, valuation methods like multiples (e.g., sales or cash flow multiples) [Wright/Robbie (1998); see also chapter 7.4.4.2.2]. In addition, the negotiations cover questions such as the volume and terms of the VC company's equity investment in the company and the time horizon of the investment (including potential exit objectives). Moreover, milestones in the venture capital process are planned and fixed within the contract to be signed. Such milestones set incentives for aligning the interests between the venture capitalist and the entrepreneur; often they are used to implement financial staging, i.e., the VC company provides its investment in different tranches only if the enterprise has achieved the pre-agreed milestones [Kaplan/Strömberg (2003); Brachtendorf (2004)]. Typical milestones include, customer, sales and break-even targets and dates at which capital will be invested in the enterprise. Here, also procedures for further financing rounds are to be laid down.

Other financial terms concern the distribution of future profits as well as planned capital increases and rights issues. Also possible forms of exit and the associated rights and obligations of the contract parties are to be negotiated. "Other" aspects refer to the working contracts of the management, reporting duties and controlling rights. In addition, the type and quantity of management support for the investment are to be regulated. In principle, many details are contractually laid down in order to agree clear regulations for the VC company on the one hand and the capital-searching enterprise on the other. From the perspective of venture capital investors, the paramount reason for insisting on such detailed contracts is the uncertainty in the value of the innovative enterprises they invest in as well as potential information asymmetries and opportunistic behaviour of the better-informed entrepreneurs [Wright/Robbie (1998)]. In the pre-investment phase, VC companies take precautions against opportunistic information disclosure (e.g., the above screening, due diligence and evaluation measures). However, also contractual regulations are used to combat the agency risks and uncertainty involved in making venture capital investments in start-up enterprises (see below). Also in the later (post-) investment phase there is potential for opportunism to be addressed through specific contractual arrangements [Gompers/Lerner (1999, 2000)].

**Investment Phase**

Within the investment phase, the venture capital company typically pursues substantial monitoring and support (e.g., consultation) activities.

According to the explanations offered by neo-institutional financing theory, there are information asymmetries between the VC company on the one side and the portfolio companies on the other even during the investment phase. [For an overview of financial agency theory in the context of entrepreneurial finance see Denis (2004).] These asymmetries lead to problems (agency risks) between the *principal* (VC company) and the *agent* (entrepreneur/founder team). The following problem areas can be identified: *hidden characteristics* (in particular before contract conclusion), *hold up* (before/after contract conclusion) and *moral hazard* (before/after contract conclusion). **Hidden characteristics** refer to *opportunistic information disclosure by the agent, i.e., hiding characteristics* about the quality of the venture project and of the contract partner, which cannot be recognized or judged by the principal before contract conclusion. **Hold up** means the opportunistic exploitation of contract loopholes by the agent which may occur in the course of the investment phase because contracts will be incomplete in that they cannot include all future developments (entrepreneur/founder team). Loopholes in the contract allow the agent to adopt a consciously damaging behaviour which is disadvantageous for the venture capital investor. **Moral hazard** concerns those cases in which the principal (VC company) cannot judge the behaviour of the agent (entrepreneur/team) both before and after the closing of the contract. If, for instance, a problem case occurs, the VC company cannot decide whether this situation has been triggered off by the behaviour of the entrepreneur or by changes in the environment. [For more details on general agency aspects in general neo-institutional finance theory see Spremann (1990); Göbel (2002); Richter/Furubotn (2003); for agency and information asymmetry aspects within entrepreneurial and venture finance see Sapienza/Gupta (1994); Shane (2003); Stouder/Kirchhoff (2004); Denis (2004).]

The post-contractual problem areas of principal-agent-relationships in the venture capital context can be reduced by introducing *monitoring* (principal) as well as *signalling* (agent). Against the background of the agency problems described above, it should become clear why **monitoring** is so important from the point of view of a VC company. [A survey of monitoring instruments used in the context of venture capital companies is provided in Robbie et al. (1997).] The monitoring system is formalized and fixed with regard to time. Within this system, figures from the management of the running business as well as from the enterprise's balance sheet and the profit-and-loss-account are to be submitted. Additionally, information about new products, for instance, their development status, the planned costs of the development or the costs of market entry are significant. Information regarding turnover, cash flow, liquidity or the development status of the enterprise's investment projects, are to be made available. The reporting periods can vary considerably (e.g., monthly, quarterly, every six months). Moreover, ad hoc reports are an option. What really counts is, however, an intensive regular contact, even beyond predefined reporting periods.

The VC company also provides *support* (in the form of consultation and network contacts, e.g., to potential technology partners or suppliers), usually by offering know-how which can serve to create new business opportunities (value-adding) or to recognize possible dangers. The latter is particularly important as an investment cannot only be endangered by the exploitation of information asymmetries from the point of view of a VC company, but also through “regular” entrepreneurial activity due to the substantial operational and market uncertainty surrounding innovative start-up enterprises [Fiet (1995)]. Here an extensive information flow between both partners is important, as a **support** through the VC company can only be successful if the young enterprise makes all necessary data and information available. Sometimes the VC company recognizes imminent dangers or problems more quickly than the young enterprise itself. This may be due to the wider experience background of the VC company. Moreover, young enterprises or their founders are often overstressed by the work load, lacking the time to pay attention to early warning signals.

**Disinvestment**

The exit of the venture capital company follows after approximately three to seven years of investment. The financial proceeds of the investment relative to the amount originally invested in the enterprise corresponds to the interest accumulated on the employed capital, finally indicating whether the anticipated risk-adjusted return has been achieved against the background of other investment alternatives as opportunity costs.

#### 6.3.4.4 Exit Alternatives in Venture Capital Financing

The exit of the venture capital investor (disinvestment) must be planned with care in cooperation with the management of the enterprise. An essential task of the VC manager is to explain possible exit strategies. Due to their extensive experience in dealing with the capital market, in this particular phase venture capitalists will also be important as consultants, developing an adequate exit strategy with the entrepreneurs. [See Gompers (1995) for large-scale empirical evidence on financing rounds and exit strategies for the case of 800 venture capital backed enterprises in the United States; for the European case see Bottazzi et al. (2002) who particularly focus on exiting via initial public offerings made by young growth-oriented enterprises.] The following **exit channels** are the main alternatives:

- Initial public offering (IPO)
  First security flotation of the enterprise at the stock exchange
- Trade sale
  Sale of the shares to industrial strategic investors
- Buy back
  Buying of shares through the enterprise and the entrepreneurs
- Secondary purchase
  Sale of shares to another institutional financial investor
- Liquidation/write-off
  Usually realization of a partial or total loss

The first four disinvestment options represent active strategic measures. However, the buy back of the shares by the enterprise is seldom used in practice. Liquidation occurs only when all other disinvestment channels are no longer feasible.

**Initial Public Offering**

**The initial public offering (IPO)** is the term for the *first issue of the enterprise's shares at a stock exchange.* Other synonymous expressions are "being listed at the stock exchange" or "going public" [for empirical evidence regarding this exit path and the performance of venture capital backed enterprises which went public in Europe see Rindermann (2004)].

The **transaction of an IPO** can be divided into different phases. The first phase comprises the *examination of the basic negotiability of the enterprise.* This phase is followed by the determination of the *number of syndicate leading banks* which will accompany the initial public offering. Within the framework of the preparation of an IPO, *an equity story is developed and communicated* by the young enterprise as well as by the syndicate member banks. In essence, the equity story explains why the share should be acquired by an investor. It may be seen as a financial marketing or initial investor relations tool. *The formal pre-IPO due-diligence procedure,* the vetting and valuation of the enterprise [see also chapter 7.4.4.2.2] is an essential step which gives a first indication regarding the value of the enterprise. On this basis, the subscription range of the shares can be determined. Subsequently, a *verification of the conditions for going public* according to the standards and requirements of the considered stock exchange segment takes place; this is usually required by stock exchange commissions in order to maintain the quality of companies listed in the different market segments bearing in mind that not every enterprise is suitable to go public. In particular, strict formal qualitative and quantitative conditions must be met for an admission to the stock exchange. As basic conditions for the admission, the Companies Act of the country where the enterprise is going to be listed and the relevant regulations of the individual stock exchanges will apply. For example, enterprises planning to get listed need to have an adequate legal form, typically a joint stock company. As regards the necessary formalities, annual financial statements and quarterly statements must be disclosed to the capital market. The underlying purpose is the generation of transparency. The legal admission regulations are often laid down in institutional rules like *Stock Exchange Acts*, S*tock Exchange Admission Rules, Securities Prospectus Acts,* as well as in the general stock exchange rules.

If all conditions are fulfilled, a *subscription prospectus* is to be drawn up and a *time schedule* is prepared. The initial public offering itself will be accompanied by specific *marketing measures.* In principle, in Europe, there are two **access routes to the capital market.** First, there are the *EU regulated markets,* secondly, there are the *regulated unofficial markets,* i.e., markets which are regulated by the stock exchange itself. While there is substantial Pan-European harmonization of capital market standards and entry regulations, there are country-specific differences, in particular for the latter case of regulated unofficial markets. For young and fast-growing enterprises the path to going public is therefore quite demanding and requires paying attention to both European and country-specific legislation. Finally, entrepreneurs (and venture capitalists) should also bear in mind that entry regulations to stock markets have become more challenging after the slump of new economy start-ups in 2001 and 2002 and perhaps will become even more severe in the aftermath of the 2008/2009 crisis of global capital markets.

**Trade Sale**

An alternative to going public is the so-called trade sale. A trade sale involves the complete or partial sale of enterprise shares, for example, to strategic investors. Through their acquisition, strategic investors hope for entrepreneurial advantages for themselves, e.g., turnover growth, gaining market share, synergies or additions to their own product portfolio, or access to new technologies. In contrast to going public, the essential advantage of a trade sale lies in the fact that no minimum requirements (admission, prospectus preparation etc.) must be met. Furthermore, the sales price is determined through negotiated enterprise valuation, fixed in a contract and, as a rule, paid directly. However, the trade sale can be a challenge. In particular, the search for and negotiation with potential strategic investors can prove to be difficult in the sales process. For the entrepreneurs, a trade sale to a strategic investor often means to lose independence and managerial control and hence it is often difficult to align interests between the parties involved in a potential trade sale to be negotiated.

**Buy Back**
A buy back refers to the re-purchase of the shares by the founding entrepreneurs or senior management of the enterprise. In this case, the VC company acts as a vendor who sells his/her shares back to the enterprise. Sometimes this exit option is taken because the initial contract between the venture capital company and the enterprise includes pre-emption rights, allowing the entrepreneurs to exclusively purchase any offered shares. A typical problem with buy backs in general is the fact that the enterprise will require additional funding to finance the purchase which is often difficult to arrange in absence of other external investors available to the enterprise [Pankotsch (2005)].

**Secondary Purchase**
The concept of secondary purchase refers to the sale of shares to other institutional investors (financial investors). Such a financial investor can, for example, be another venture capital company. The buying VC company can have various motives for a secondary purchase. It may, for instance, specialize on later phases in enterprise development (e.g., buying what has originally been a seed investment which has now entered the expansion stage). In addition, it may sometimes have a comprehensive know-how in a specific business-line allowing to add more value to the enterprise than the company will have to pay in the secondary purchase. In most cases, the buying VC company is in a position to get a better deal and enter into a higher equity participation than the selling VC company. Within the framework of the secondary purchase, not only sales of individual investments are common. In the case of time-limited venture capital funds, also complete investement portfolios are sold to other financial investors. A further possibility of using the secondary purchase option is the exit of a VC company ceasing its venture financing business.

**Insolvency/Write-off**
The worst form of exit imaginable is insolvency, both from the point of view of the venture capital company and the entrepreneurs. If insolvency is imminent, a value adjustment has to be carried out. If the insolvency actually materializes, a write-off is carried out on the investment in the books of the VC company. Even though the VC company (and the enterprise) take substantial screening and monitoring measures (which incur substantial transaction costs) the business of investing venture capital in young enterprises often operating in novel industry sectors by definition also thus involves inevitable investment failures. This risk of new venture failure also makes debt financing challenging to new and young enterprises [cf. the discussion below and Mason/Stark (2002) who in particular stress the substantial risk of credit failure in comparison to the limited upside potential and high transaction costs involved in making loans to new and small enterprises].

## 6.4 Debt Financing

In contrast to the Angelo-American domain, the finance and banking system of a number of Continental European countries (in particular Germany's) was historically dominated by credit institutes for many decades after the Second World War. At the same time, the financing culture differed markedly from other financing cultures as, for instance, that of the USA with its strong focus on equity financing. Even today, the high share of debt financing (financing through borrowing capital) in Japan, France or Germany stand in contrast to the high share of equity capital financing in the USA. As far as Continental Europe is concerned, Huyghebaert et al. (2007) constitute that banks are still the most important providers of outside start-up funding to newly founded businesses. Particular characteristic features in the development of the banking sector in Continental Europe are the **universal bank system** and the **house-bank principle.** A universal bank system means that, in difference to a specialized bank system, credit institutes carry out all banking transactions, e.g., including investment banking operations. Notwithstanding the current changes in the US investment banking industry on account of the 2008/2009 financial crisis the specialized banking system on the other side of the Atlantic still shows substantial differences. For example, the structure of the banking sector in Germany is divided into groups of credit banks, banks under public law, cooperative banks and specialized banks, the first three of which can be called universal banks [see Berger/Udell (2002) for the importance of bank structure for small business lending]. The house-bank principle means that a customer conducts a large part of his financial transactions with one individual bank [also cf. Kohn/Spengler (2008) for the reliance of German business on non-traded debt funding via banking intermediaries]. Even today, small and medium enterprises in Germany have only one or two banking relationships. In more recent times, however, other outside financiers, e.g., institutional capital providers, have gained increasing importance. In analogy to the differentiation between *private equity* and *public equity*, various forms of *private debt* and *public debt* can be systematically differentiated in the debt capital sector [for details see Achleitner/Einem/Schröder (2004) and Wahl (2004)]. Under this perspective, other forms of enterprise financing – in addition to the *classical bank credit* – can be summarized under **private debt in the widest sense,** which are mainly placed by institutional capital providers *privately and not in an organized, anonymous capital market.* The capital which is made available by institutional or private capital providers outside the banking sector is also called **private debt in the narrower sense.** It concerns forms of first-rank and subordinate rank debt financing as well as mezzanine financing which, as direct financing, are made available with a time-limit, usually for five to ten years [Achleitner (2005); also cf. Denis (2004)]. In contrast to non-traded commercial debt, public debt comprises financing forms which are quoted o*n the organized, anonymous capital market for corporate bonds (at the stock exchange).*

### 6.4.1 Concepts and Forms of Debt Financing

Debt financing can be classified in many ways. Often a differentiation is made according to the criterion of time pattern, i.e., the duration of the possible life of a credit. In contrast to equity capital, borrowed capital is made available to the enterprise with short, medium or long term. Credits up to a year are usually called short-term and those with a duration of more than a year and up to four years are medium-term [for typical forms of short- and medium-term credits see, e.g., Timmons/Spinelli (2004)]. Long-term credits have a duration of over four years.

### 6.4.2 Short-term Debt Financing

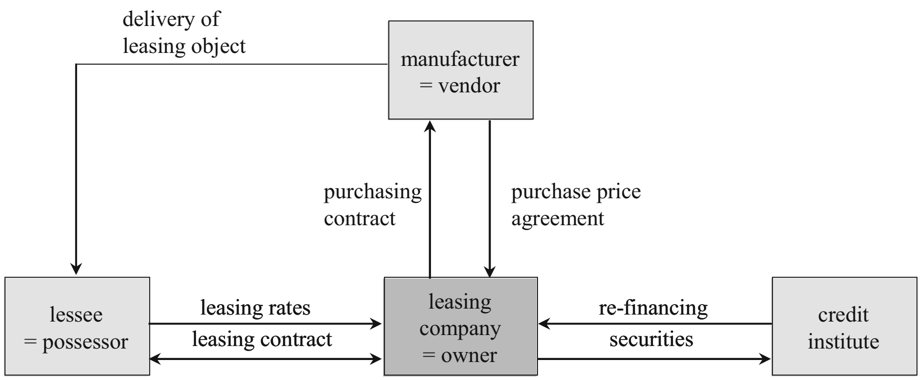
Short-term debt financing is primarily required for **financing current assets** and working capital to improve liquidity. In the course of the business process to finally generate sales revenues (operating cycle), cash in- and out-payments occur at different points in time. The resulting differences must be bridged over financially (typically via short-term bank credit lines, e.g., current account overdraft facilities).

In addition to these short-term instruments of bank financing, other forms of short-term debt are also important in entrepreneurship practice (e.g., supplier credits or customer prepayments). A survey of typical **bootstrap financing** methods (i.e., instruments which do not rely on institutionalized debt capital such as bank loans) which are used in small and new business funding indicates that business founders and small business owners use a fairly wide range of *non-standard tools to enhance short-term liquidity* [Winborg/Landström (2000)]. In addition to the above-mentioned forms, founders seem to use funding via founders' personal credit cards (Stouder/Kirchhoff (2004); (temporarily) granting lower (non-market) salaries to employees and management; delaying payment to business partners; taking on assignments in other businesses (moon-lighting) and others. The list of bootstrapping forms suggests that some instruments do not really involve taking additional capital on board but rather generate (short-term) liquidity, i.e., serving as a substitute for external debt financing. Two other instruments in this context are leasing and factoring as alternatives to an outright purchase of assets.

The process of **leasing** to a young enterprise refers to the *surrender of use against payment of movable or immovable economic goods (assets) or labour to the young enterprise.* In turn, the young enterprise acquires the right to use these assets (e.g., cars or computers); typically the enterprise (lessee) has to make a series of periodic payments to the lease provider (lessor) who remains the owner of the assets. Lessors can be the manufacturer of the economic goods themselves (direct leasing) or financing institutes or leasing companies (indirect leasing).

Illustration 6-9 shows an example of the relationship between the participants in leasing.

***Illustration 6-9:*** *Representation of a leasing process*



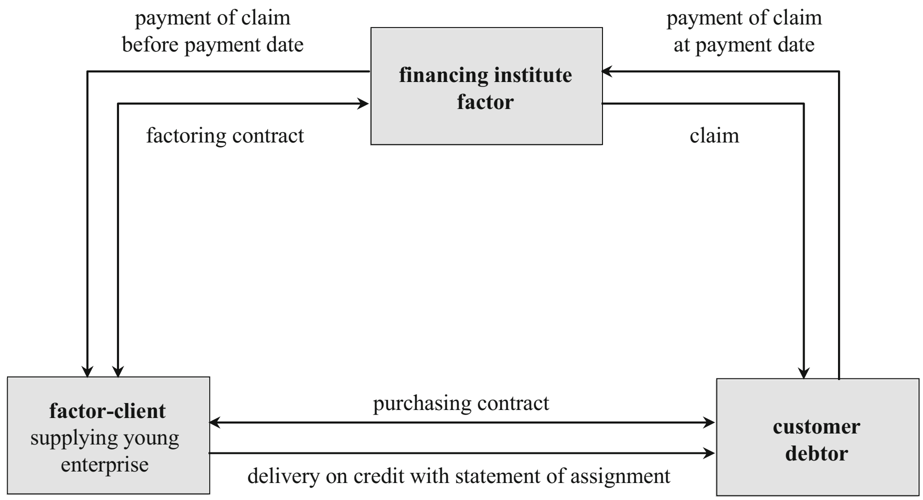

The *improvement of the liquidity situation* as a result of the leasing can be particularly important, especially for young enterprises. In addition, leasing instruments offer scope for many and diverse flexible forms and are, therefore, associated with many advantages, especially for young enterprises. The typical expensive examination and approval processes of obtaining a bank loan are often reduced in leasing. Liquidity and possibly also credit lines are maintained, which leads to a wider financing scope for the lessee. The leasing objects serve to secure the leasing relationship without requiring the furnishing of additional collateral. However, leasing does not always lead to a relief of the debt situation, as banks also take into account any leasing obligations of the credit user in their examination of his/her credit worthiness. Too, in comparison to a bank loan, leasing is often the more expensive type of funding. In most cases, leasing companies charge a final acquisition fee to the sum of up to 5 percent of the purchasing costs of the leasing objects, and the leasing rates mostly run to 120 to 150 percent of the purchasing price during the duration of the contract.

Whether and to what extent leasing can be a financing alternative for a young enterprise, is to be decided individually according to the specific requirements of the business and on the basis of the offers of the respective lessor. In the future leasing could gain increasing importance for young enterprises as a substitute for bank credit, in particular as a result of Basle II regulation which may make bank loans even harder to obtain for young enterprises (see below). As the leasing objects usually do not remain with the lessees, the result for the enterprise is an improved balance sheet situation which might have positive effects on one's credit rating.

**Factoring** is the contractually fixed *purchase of current short-term claims originating from the sale and delivery of goods or services of an enterprise within an agreed maximum limit (debtor limit).* In most cases, the purchase is carried out by a factoring institution (the *factor,* e.g., a factoring company or credit institute) before payment date. The factor usually takes over certain service functions and often also bears non-payment risks. Claims are only sold in totality and not as individual claims. Depending on the form of contract, the vendor of the claims also transfers cash-management operations such as debtor accounting, debt collection and the dunning process to the factoring company. As a rule, a payment quota of 80 to 90 percent of the claim sum is agreed between the factor and factoring user. A residual quota remains as surety to cover possible discounts by the factoring company, but it will be paid out to the factoring user when the payment is received.

Illustration 6-10 shows the essential relations between factor (financing institution), factoring client (supplier of claims; in our case the young enterprise) and a customer (debtor).

***Illustration 6-10:*** *Representation of a factoring process*




In general, factoring has the following functions:

- Financing function
  (Assessment of the credit standing of the customer, purchase and crediting of the claim – generating additional liquidity for the factoring-client)
- Service function
  (Administration of accounts receivable, debtor accounting, dunning and collection system)

- Delcredere function
  (The factor takes on the risk of non-payment of the claim)

An important **advantage for the vendor** of the claims consists in the fact that the resources bound in the claims of the enterprise are released early so that *liquidity is improved.* The sold claims from the delivery of goods and services lead to an inflow of liquid financial resources immediately after their occurrence. However, **factoring fees** will arise for the **vendor**. These depend on the turnover and the estimated non-payment risk. In addition, interest for the advance against the claims are typically charged. Generally, those young, growing enterprises are suitable for factoring, which generate profit, show an annual turnover of at least 250,000 Euro and grant payment terms of up to 90 days. To some extent, factoring companies have however specialized in smaller enterprises which generate a minimum turnover of, for example, 50,000 Euro. The claims must be against business customers (debtors) and be the result of the delivery of goods and services. A further condition is that the claim structure and overall volume should be constant to a large extent and the sums of the individual claims are not too low. Young enterprises, which can consider factoring, should weigh up carefully the associated costs and advantages. In the growth phase, in particular, the inflow of liquidity as a result of factoring can be used for further business expansion. It may also not be profitable for a young enterprise to build up or reserve own capacities for taking on service or delcredere functions.

Apart from the above alternative bootstrapping tools to establish a financial basis for one's business, employing traditional bank overdrafts is a classic financing method which is frequently used by entrepreneurs and small business owners.

#### 6.4.2.1 Current Account Credit

**Current account credits** are the *classical short-term credit form* and the most common tool of short-term debt financing. A current account credit can be used by the beneficiary according to his/her requirement and up to the contractually agreed limit (credit limit). In the case of enterprises, the transaction usually takes place via a current business account.

Current account credits are used in practice as *working assets, turnover, intermediate financing credits* as well as *bridging* and *seasonal credits.* They serve above all to *finance the short-term assets of the business.* According to sound financing rules, an existing free current account line should, however, *not* be used for acquiring long-term fixed assets, the main reason being that the debit interest rate for current account credits normally lies above the interest rates for long-term loans and is therefore relatively high; also, long-term assets financed short-term would require frequent re-financing efforts by the management of the enterprise. However, the principle of **matching maturities** of fixed, long-term assets and current assets on the one hand and corresponding long- and short term financing sources on the other is often neglected by young enterprises.

Current account credits serve to improve liquidity and thus to secure the continuous ability to make payments. Formally, current account credits are only granted as a form of short-term credit, de facto they run however, as a rule, over many years due to repeated prolongations. A prolongation is not granted if, for instance, the economic circumstances of the debtor continue to deteriorate and no additional credit collateral can be provided. Typically in such circumstances banks tend to "call in" existing credit lines to a business.

If the granted credit line is overdrawn, the creditor charges an overdraft interest in addition to the debit interest rate. For furnishing securities, all the usual forms of collateral can be considered. The advantages of current account credit are its flexibility, the availability for all the usual bank transactions and the uncommitted use. The main disadvantages are the potentially high costs of current account advances and the threat of a cancellation by the bank on sometimes very short notice.

#### 6.4.2.2 Supplier Credit

In differentiation to institutional debt financing through loans granted by banks, credit given within the framework of the delivery and payment traffic of enterprises and suppliers is called trade or supplier credit. Typically, trade credit is an option for enterprises when facing difficulties to access capital markets [Asselbergh (2002)]. A **supplier credit** is generated when a *supplier grants a certain payment term to customers.* The supplier can, for example, give a customer a discount on the purchasing price (**trade discount)** if the invoice is settled within a certain discount term (e.g., ten days), i.e., as quickly as possible. After the discount period has expired, the customer is granted a **respite**, which normally comprises a period of ten to 90 days. Founders should note though, that while being a convenient form of short-term funding, taking credit from suppliers is usually fairly costly. A short example shall illustrate why supplier credits can be seen as an expensive form of debt financing. The example is structured simply, and its approximate formula does not take into account any interest rate under a year. The simple formula for calculating the interest rate (p) to be paid for a year is:

$$p = \frac{discount\ rate\ in\ \%}{respite - discount\ \ period} = \frac{S}{z-s} * 360$$

where (S) is the discount rate, (s) the discount period and (z) the respite. The difference between the respite and the discount period (z – s) is called discount margin.

For the above example, the following concrete data shall be assumed: (S) = 3 percent (discount), (s) = 10 days (discount period), (z) = 30 days (respite). The result would be

$$p = \frac{3\,\%}{30-10} * 360 = 54\,\%$$

The interest rate derived from these data would be 54 percent per annum. The interest rate determined in this way naturally appears to be high compared with the current interest rate of a bank credit. More precisely, the annual interest rate can be calculated using the following formula:

$$p = \frac{\dfrac{\textit{discount rate in }\%}{100\,\% - \textit{discount rate in }\%}}{\textit{respite} - \textit{discount period}} = \frac{\dfrac{S}{100\,\% - S}}{z - s} * 360$$

A typical **characteristic of supplier credit** is the *close relationship to the sales of goods by the supplier.* The amortization occurs from the sales return of the credited goods, i.e., no financial means are made available directly, but a respite is granted at the purchasing price. A supplier credit can, for example, be a measure of sales promotion or it can be forced upon by competition pressure. In difference to bank credit, suppliers are not interested in granting a credit because of their interest in the credit business, but because they want to increase their turnover, i.e., financing the sales of their products. Normally, the discount sum has already been included in the calculation of the price offer and is therefore contained in the selling price. From the perspective of the founder of a young enterprise using supplier credits, one advantage is the relatively uncomplicated handling compared with other types of credit. In comparison with a bank loan, a supplier credit is advantageous in so far as it is informal and is given without requiring any special securities. Possible disadvantages consist in strong economic dependencies, relatively high costs and the vendor's lien of the supplier (to secure his claim, the supplier retains the title on the supplied goods).

Supplier credits often become important when the capital equipment and the liquidity of an enterprise are low and insufficient collateral is available to be able to borrow from the bank, which typically acts as an asset-backed lender demanding for securities before providing credit. [See Stouder/Kirchhoff (2004); also see Berger/Udell (2003) for different lending technologies used by banks; for the choice of entrepreneurs between bank loans and trade credit see the study by Huyghebaert et al. (2007).] With young enterprises, there is also the risk that in the case of liquidity problems, supplier credits are not only used for financing current assets, but also to finance long-term committed assets. This procedure can in an extreme case lead to insolvency when the refinancing of long-term assets critical to the enterprise's business operations is difficult to obtain for the entrepreneur.

### 6.4.2.3 Customer Prepayments

Another form of financial bootstrapping and short-term cash management are customer prepayments (customer credits). In the case of **customer prepayments,** *the customer makes a payment before receiving the goods or services.* They form a type of *prepayment credit* through the customer, who thus appears as a creditor. In most cases, customer prepayments do not earn interest. They are therefore a very favourable financing source. Prepayments through customers are primarily customary in capital-intensive industries, such as, for instance, the investment goods industry (machines, airplanes, ship-building etc.) as well as the building industry, as the exclusive financing of the production by the manufacturer is not feasible because of the long production times and the high production costs. [See again Shane (2003) for the fundamental problem of new businesses requiring to fund business operations before future sales.] In young enterprises, customer prepayments play a role occasionally, e.g., in the consulting industry and also in internet projects. While prepayments by customers may offer a fairly inexpensive means of funding, the following should be noted. Generally, customer prepayment policies may jeopardize marketing and sales efforts. This is particularly problematic for young enterprises that lack trust and established customer relationships anyway, at least at the time of initial market entry. This may make it difficult to implement this way of financing in practice as customers may not accept making advance payments to new, unknown enterprises. In the end, founders need to balance the potential financial advantages of prepayment policies against possible drawbacks from a marketing perspective.

### 6.4.3 Medium- and Long-term Debt Financing

Medium- and long-term debt financing are normally tied to a specific purpose and serve above all to finance the fixed assets of the enterprise (e.g., acquiring or replacing production facilities, the construction or purchase of business premises). The borrowed funds with usually fixed interests are to be paid out and repaid at contractually fixed dates. Medium- and long-term debt financing to new and small enterprises are granted by institutional lenders such as banks as well as by the state (in the context of public enterprise policy) and private financiers (e.g., friends or family members). The following discussion will concentrate on these sources of debt financing typical to entrepreneurial finance (friends and family loans, bank credit, and micro-lending as a typical form of small and new business finance; at the end of chapter six also public sources of funding will be briefly addressed from the perspective of public enterprise and small business policy-making).

In contrast to large, established companies, new and small enterprises are not able to access the corporate bond market for funding and typically have "to go through the bank" to take on commercial debt [Berger/Udell (1998)]. Possibly only after substantial enterprise growth and an establishment and confidence-building process may corporate bond issues on the market become feasible [Miarka/Troege (2005)]. In this trust-building process with financial market investors, the credit screening and monitoring process of banks plays an important role as a signal for quality of start-up businesses (see the section on banks' credit screening processes below). As this establishment step has been achieved by a (then) larger young enterprise, debt financing instruments other than bank credit or friends and family loans become conceivable. One of the instruments with comparatively low market entry barriers is so called open market credit (in financial terminology so called loans against borrower's note). A loan against borrower's note is not a commercial paper listed on the stock exchange but rather a form of debt financing which is placed privately with individual institutional investors (private debt). Loans against borrower's note can also be considered by larger young enterprises with an excellent credit standing, as the minimum financing volume of around 50,000 Euro is fairly low. The decisive factor here is the readiness of the investors to take risks, as the risks are usually clearly higher in the case of large young enterprises with growth potential as compared to big, fully established enterprises. It may therefore be assumed that the number of potential investors is rather low. In individual cases, it should be checked against specific criteria, e.g., costs, whether a loan against borrower's note is in fact advantageous compared to a long-term bank credit.

Overall, at an earlier stage of enterprise development bond market financing is at present only available to a very limited extent and only for very rapidly growing young enterprises gaining in size quickly; this is against the background of the high costs and strict requirements associated with the emission of corporate bonds. Compared with large enterprises, young enterprises are at a disadvantage with regard to bond issues due to their normally smaller size and poorer credit standing.

#### 6.4.3.1 Loans from Friends and Family

Generally, the costs of a loan depend on the nominal interest rate, payout ratio, commission of the loaner and any other costs. Depending on the type of interest and amortization payment, one can distinguish between instalment loan, annuity loan and fixed loan, of which the latter is often the most expensive form. The degree of detail in loan contracts will depend on the characteristics of the lender.

As far as private loans from people personally known to the entrepreneur are concerned, credit arrangements and terms are typically far less formally determined as compared to the case of institutional lending by banks and their elaborate credit screening and contracting process (see below). In other words, funding sources based on personal relationships (e.g., friends or relatives) may be accessed on a fairly informal basis and often repayment modalities and the time of redemption of the loan will not be fixed beforehand. While private loans may also follow non-financial objectives connected to the relationship with the entrepreneur, friends and family creditors normally still expect to get their money back at some point [Brachtendorf (2005)]. Stouder and Kirchhoff (2004) too suppose that this group of financiers will also be concerned about failure risks and loan defaults, just like institutional lenders are. The uncertainty about business sustainability surrounding start-up projects also sets formidable challenges to convincing others to provide resources to the enterprise, even if the entrepreneur has a more-or-less close existing relationship with the resource holders.

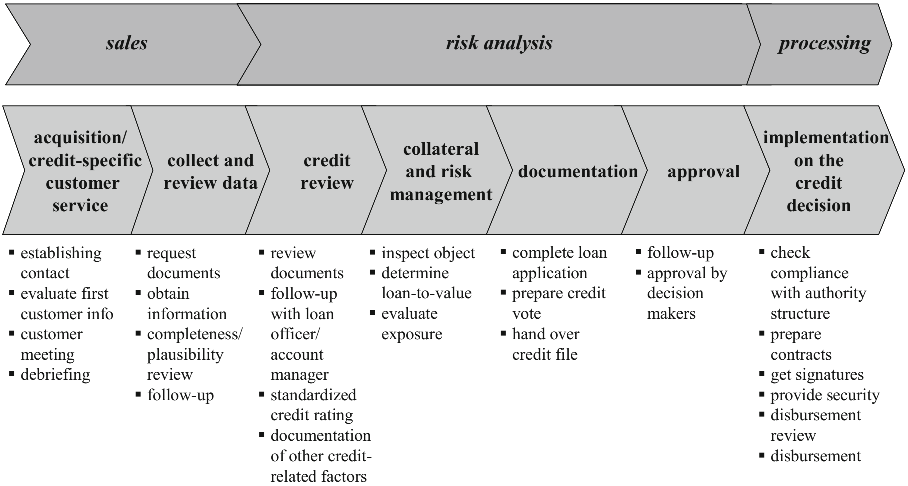
### 6.4.3.2 Credit Granting Process from the Point of View of the Bank

Even though banks' investment screening and monitoring may be less intensive as compared to venture capitalists (Winton/Yerramilli, 2006), bank credit may still be fairly difficult to obtain by young and risky start-up enterprises [Denis (2004)]. As noted elsewhere, banks often act as asset-based lenders, demanding for collateral in face of risks of credit default (defaulting of a loan occurs when a young enterprise can no longer make amortization and interest payments on the loan) [Stouder/Kirchhoff (2004)]. The underlying issue, which complicates loan financing relationships between banks and start-up enterprises, is the limited participation of the bank in the future success (upside potential) of the start-up business (in case of a traditional bank loan all the bank receives back is the redemption of the loan and a risk-adjusted annual interest payment, regardless whether the business stays small or successfully grows into a multi-billion global enterprise). This is also why banks are assumed to focus on reducing the risk to lend to failing enterprises rather then to combat the risk of missing opportunities to lend to successful new ventures [Mason/Stark (2002)]. To address the former risk, banks engage in an elaborate credit screening (or checking) and monitoring process.

The complete **process of credit granting** is *complex and comprehensive*, as it must take into account the specific economic circumstances and characteristics of each individual enterprise inquiring for credit. In the end, each credit decision is always an individual decision referring to the potential borrower. Moreover, banks have moved to an increasing level of institutionalization and standardization of instruments to assess the creditworthiness of potential business founders, e.g., through credit rating or scoring tools [Berger/Frame (2007)]; some of these instruments have been implemented on account of the Basle II Accord, which addresses banks' policies and instruments to monitor and handle credit risks (see below). In the following passage, we will illustrate those process elements which are typical for credit check and monitoring processes in commercial banking. This representation does, however, not lay claim to completeness. The aim is rather to point out *characteristic aspects of the lending process* and its particular challenges and problems with regard to young enterprises.

Illustration 6-11 shows the typical course of a credit approval (screening) and credit risk management (monitoring) process from the point of view of the bank [adapted from Austrian National Bank (2004)].

*Illustration 6-11:* *Aspects of credit screening and monitoring*




The **course of a credit screening process** traditionally starts with the **credit acquisition** by the account manager of the bank (from the banking perspective this is a sales function despite the fact that this is a screening and selection process). The account manager provides, analyses and documents data and information about the economic situation of the credit applicant as comprehensively as possible. In a preliminary examination, the account manager first determines whether the volume and the term of the desired credit are at all in proportion to the available documents (e.g., the business plan of the firm and its aims) of the client. If the result of this rough preliminary examination is positive, the account manager's report and the complete documents of the customer are passed on to the credit department. The **credit worthiness examination** of a bank aims at generating transparency with regard to the risk of a potential credit commitment. The examination of the credit standing normally refers to quantitative economic (historic and future-related) data as well as to qualitative aspects with regard to the enterprise asking for credit. This data typically reflects both decision criteria in traditional credit checks (like the business experience of the founder or the market potential of products) as well as dimensions of credit rating procedures which have been implemented on account of Basle II regulations (see below). A typical characteristic of young enterprises is, however, that they have neither a *credit history* nor an *established reputation* on the market. Therefore, the risk potential as regards the ability of the enterprise founder to pay back a credit is generally difficult to estimate. In the case of a credit to be granted to newly founded or young enterprises, three aspects of the bank's credit commitment are in the foreground:

- Transparency and plausibility of the submitted business plan (in particular of the financial plan),
- the founder persons and their competences as well as
- potential collateral securities with a stable and sustainable value which are available for securing the commitment.

A business plan which is sound and transparent and indicates economic feasibility for the foreseeable future constitutes the best basis for obtaining a credit approval within the framework of the **credit negotiation and approval decision.** At this stage, the attention of the banks often strongly focuses on the assessment of the financial plan and its assumptions made by the entrepreneurs. It is above all of interest whether the budgeting forecasts sufficient cash-flows (mainly operating income plus depreciations) for the repayment of the credit (interest and amortization).

Because of the uncertainty of future business success, another essential aspect is the personal impression which the enterprise founders leave on the credit institute. If the founders are objective and precise conversation partners who show entrepreneurial thinking and economic competence, these are favourable conditions for proving their credibility and generating trust in the account managers. Typical mistakes of enterprise founders in applying for banking credit are lacking or insufficient preparation for the credit talks, a non-transparent business plan or a poor presentation of it. Therefore, it is important that the enterprise founders submit the documents requested by the credit institute at an early stage in the period leading up to the credit talks, so that the account managers can prepare themselves.

Because of the high risks and the strong failure probability of a potential credit commitment, banks insist that young enterprises furnish securities with a sustainable value. Typical securities which are normally accepted by credit institutes and their evaluation are surveyed in Table 6-5 [also cf. Timmons/Spinelli (2004) for typical collateral in new venture debt financing, e.g., chattel mortgages].

*Table 6-5: Securities and their evaluation by credit institutes*

| Type of Security | Valuation Amount |
|---|---|
| Land charges / mortgages | – hypothecary value |
| Sureties/guarantees | – regulation of maximum value in the surety contract |
| Life insurance policies | – re-purchase value |
| Building society contracts | – accumulated deposit balance (plus interests) |
| Fixed deposits, saving accounts, saving certificates | – to the full sum |
| Fixed-interest commercial papers | – usually 75% of market value |
| Shares | – domestic standard stocks: usually 50%<br>– foreign standard stocks: individual regulations |
| Chattel mortgage (e.g., machines, equipment, vehicles, warehouses etc.) | – items assigned by way of collaterals remain the property of the client; the credit institute becomes the owner<br>– evaluation according to the foreseeable sales price |
| Assignment of claims | – evaluation of the claims of the customer at a certain percentage (taking into account claims failures) |

Within the framework of the bank's risk analysis, a credit rating (risk factor) of the young enterprise is usually established, which forms the basis for determining the credit terms. In this context, the regulations of the *Basle II Accord* are important (New Basle Equity Agreement) [see, e.g., Jacobsen et al. (2005) for the nexus of small business financing and Basle II]. The Basle II regulation has been put forth by the Basle Committee on Banking Supervision of the *Bank for International Settlements* (located in Basle, Switzerland). In particular, Basle II represents a new regulation of the equity provision guidelines of credit institutes which aims at increasing the stability of the banking sector and the international financial system. So far, elements of the Basle II regulation framework have been adopted particularly in the EU (e.g., in the Capital Requirements Directive or CRD) while the implementation in other countries (e.g., the US) is delayed.; however, due to the 2008-2009 financial crisis, global capital market regulation is likely to intensify in the future as governmental organizations and policy makers strive to combat systemic risks to financial market stability. For example, it may be that additional demands for higher minimum-equity requirements in the banking sector may be put in place in the future [cf. Jacques (2008) for capital market shocks, potential regulatory consequences in general, and revisions of the Basle Accord in particular].

The fundamental concept of **Basle II** is based on the three pillars of *quantitative equity standards* (pillar 1: minimum capital requirements), *qualitative supervision* (pillar 2: supervisory review of capital adequacy) as well as *transparency regulations* (pillar 3: market discipline). The **quantitative equity standards** (pillar 1) form the main part of Basle II. There, the rules for determining the minimum (equity) capital requirements are defined for banks' balance sheet structures. The objective of the regulations of the first pillar is to take into account the risks of a bank as accurately as possible within the framework of the assessment of their equity equipment. The level of the capitalization is to be determined by taking into account three risk types, *credit risks, market risks* as well as *operational risks.* The *credit risk* or the assessment of the credit default risk is typically determined by an internal rating (bank) or an external rating (rating agency). In the case of an internal rating, the bank can choose between three approaches of risk weighting, the standard approach, the Internal Ratings-Based (IRB) approach as well as the advanced IRB-approach. Depending on the approach, different risk weights are employed. *Market risks* comprise, for example, interest change risks or exchange rate risks. *Operational* risks are defined as the risk of losses which occur as a result of the inadequacy or the failure of internal procedures, bank employees and systems, or as a result of external events. All three risk approaches are required for calculating the required equity capital base of a bank to back its credit business. In pillar 2, the **qualitative supervision** of Basle II, the qualitative examination by the bank supervision authorities is defined. With pillar 3, the **transparency regulations**, a strengthening of market discipline is intended by intensifying the disclosure of information within the framework of the external financial accounting procedures of the banks [Füser/Gleißner (2005)].

From the point of view of the bank, the analysis of the risks associated with a credit commitment is important. In the case of newly founded enterprises, these risks are particularly high [Denis (2004)]. Therefore, credit financing is normally only be considerable for young enterprises if the high risks are covered by usable credit securities. To be able to assess the risks generally associated with enterprise financing better, banks normally have a differentiated rating system at their disposal which contains a catalogue of qualitative and quantitative criteria for evaluating a potential credit commitment [cf. Schäfer (2003) who also discusses fundamental impacts and issues of Basle II for SME financing].

In Table 6-6, qualitative and quantitative criteria for the rating of enterprises are listed.

*Table 6-6: Qualitative and quantitative credit rating criteria*

| Qualitative Criteria | Quantitative Criteria |
|---|---|
| Strengths and weaknesses of management | Financial indicators |
| Enterprise strategy | Sales development, prospects |
| Market position and prospects, marketing | Earning power, cash-flow |
| Products and innovation ability | Capital equipment, structure |
| Financial accounting and controlling systems | Achievement of budget figures |
| General future prospects of the business | |

Although it is possible to negotiate credit terms and conditions in individual cases, these possibilities are on the whole fairly limited by the regulations for equity capital backing of credit commitments according to Basle II. Usually, the credit decision is carried out by the banks according to the “four-eyes-principle”. This means that a credit decision can in principle not be taken by one single person. Moreover, partly as a result of Basle II, the room for individual credit negotiations between entrepreneurs and bankers has decreased because of increasing levels of standardization both of credit screening as well as banks' credit products sold to small businesses. [For the potential consequences of standardized credit rating and scoring on the debt financing of new and small businesses see, e.g., Berger/Frame (2007).]

If the young enterprise has overcome all the difficult hurdles of the bank's risk analysis and evaluation, the credit approval and payout by the credit institute will take place (**realization of the credit decision**). However, within the overall lending process the provision of credit will be followed by a continuous monitoring of the credit relationship by the bank (**commitment supervision**), in which the young enterprise is obliged to report regularly about its economic development, the prospects of its business operations, and its financial situation. The bank must be immediately contacted if, for example, unforeseen risks occur which threaten the repayment of the loan as scheduled.

On the whole, lending to young enterprises is, in a typical case, not only tainted with high risks and probabilities of loan defaults for the credit institute, but is also an expensive and complicated process which often is in no proportion to the yield prospects. As a consequence these substantial transaction costs (relative to the size of small business loans and banks' potential profit margin) undermine the attractiveness of entrepreneurial debt financing with bankers as financial intermediaries [Mason/Stark (2002)]. Because of the bank's concerns about credit defaults, and the complex screening and monitoring instruments employed to combat these risks, entrepreneurs should be aware of the financial covenants imposed upon them when entering credit relationships with institutional lenders [Timmons/Spinelli (2004)]. Practically, many credit institutes have suffered from the consequences of a too-generous credit granting during the "dot.com euphoria", and the same may have happened during the 2008-2009 financial crisis. However, with continuously improving instruments for the management of credit processes it may be possible in the future to reduce further the risks and costs of the credit business of banks, at least at the level of credit portfolios in the banking system. In this way, the chances for young enterprises of obtaining loans could be increased in the long-term. For small and very small enterprises looking for credit, the micro-lending market, which is also developing in Europe, might prove to be a financing opportunity in the future.

## 6.4.4 Micro-lending

Micro-lending comprises the process of granting micro-size credits for the entrepreneurial activities of private individuals through public or private organizations [See Koch/Tokarski (2004)].

### 6.4.4.1 Concept and Forms of Micro-lending

**Origin and Forms of Micro-lending**
Some of the roots of micro-lending lie in the area of development politics. In Bangladesh the Grameen Bank was founded by Muhammed Yunus in 1976 (see www.grameen-info.org) with the aim of *granting short-term micro-credits to the self-employed.* Up to this point, lending by local banks had been insufficient because of lacking securities or reliable credit histories of potential borrowers. Banks such as the Grameen Bank can be quoted as prototypes for micro-lending programmes as they have made their entrance not only in the developing countries and emerging economies, but also in industrial countries, above all in the United States of America.

Continuing this history, today **two main forms of micro-lending** can be distinguished ac-cording to the development level of the respective national banking systems [Reifner (2002)]:

- **Pre-banking** micro-**lending** (developing/emerging countries)
  Characteristic: underdeveloped banking sector
  Motivation: preparation of a future banking structure

- **Social** micro-**lending** (industrial countries)
  Characteristic: developed banking sector
  Motivation: granting of credits to individuals who have so far been excluded by the banks from this opportunity.

**Social micro-lending** is designed to have a positive effect particularly in the following areas:

- The credit user and their financing scope
- The labour market
- The local or regional development
- The generation of social prosperity.

It must, however, be noted that so far it has not been possible to empirically prove a measurable success of micro-lending instruments. The above-mentioned positive effects of social micro-lending are mostly based on plausible considerations or anecdotal evidence. For instance, it is argued that social micro-lending allows individuals to participate in business life who would otherwise remain excluded either temporarily or permanently [Reifner (2002)]. See too, for example, the case of barriers in bank lending to ethnic minorities and potential financing alternatives [Smallbone et al. (2003)].

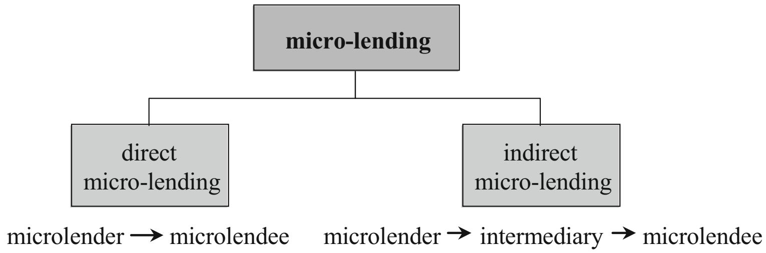
In addition to the forms of pre-banking and social micro-lending, another classification into *direct micro-lending* and *indirect micro-lending* is used, which is based on the **form of credit granting**.

**Direct and indirect micro-lending**

In the case of **direct micro-lending**, *communication, providing the credit, credit monitoring* and *credit repayment* take place directly between the micro-lender (creditor) and the borrowing micro-lendee (credit user). An immediate credit contact between the mentioned parties is thus achieved.

In the case of **indirect micro-lending**, an *intermediary is employed to support credit transactions or operate the credit business.* A *bank* can, for example, appear as an intermediary which carries out *credit issuance.* As a further possibility of indirect micro-lending, a specific *micro-lending institute* can be used as an *intermediary* between the *credit-issuing bank* and a *micro-lendee.* With this type of micro-lending, the phases of credit initiation, credit-screening/selection and credit monitoring can be managed by a micro-lending institution. From the point of view of the *lending bank,* an outsourcing of certain operational activities occurs, as it only takes on the *issuance of the credit,* while the transaction itself and the later monitoring of the credit relationship is done by the micro-lending institution. Illustration 6-12 shows the differentiation between direct and indirect micro-lending.

***Illustration 6-12:*** *Direct and indirect micro-lending*




### 6.4.4.2 Information Asymmetry of a Credit Relationship

As with other financing relationships, in micro-lending also the relationship between the credit grantor and borrower is characterized by an *asymmetry in the distribution of relevant information.* On this point, micro-lending does not differ theoretically or practically from the classical forms of credit relationship between enterprises and credit institutes. On the side of the creditor, there is usually a high level of uncertainty regarding the credit worthiness of the credit-user [generally cf. Denis (2004) for this problem in almost all areas of entrepreneurial finance]. The information with regard to the existing or non-existing credit worthiness is distributed unevenly or asymmetrically between the players and the potential borrower may opportunistically hide negative pieces of information (e.g., negative customer feedback at market entry) to obtain the loan. In order to remove this existing information asymmetry, it is necessary to demand enterprise specific figures, data and facts available in the form of financial budget data (e.g., in the start-ups' business plans) or balance sheets, profit-and-loss accounts etc. (if available). On the other side, there are the real problems of very small enterprises whose available information often falls far short of providing the level of content and completeness which is required for a sustainable **financing contract** [as argued for the general case of new venture funding by Stouder/Kirchhoff (2004)]; for the specific issue of short versus long-term lending to small businesses and information problems see Ortiz-Molina/Penas (2008)].

### 6.4.4.3 Micro-lending Contracts

The theoretical basic elements of a financing contract can be analogously transferred to micro-lending. A financing contract is a contract concerning the temporary surrender of a certain amount of capital by the lender to a borrower under precisely defined conditions. The defined conditions include on the one side standardized rights and obligations, irrespective of the specific situation of the contract partners, as, for instance, the market interest or the duration of the contract. On the other side, it contains individually adapted rights and obligations which depend on the specific situation and can become part of the financing relationship, for example, individual risk surcharges in calculating the interest rate to be paid.

The preparation of micro-lending contracts is to be adapted in a modular fashion to the individual risk and earning profiles of the individual contract partners. Essentially, micro-lending contracts are, however, distinguished by two characteristic features. Firstly, they have a **low credit volume**, and secondly they are characterized by a **short credit term**, usually under a year.

#### 6.4.4.4 Practical Forms of Micro-lending

In contrast to the conventional lending procedures or lending technologies [Berger/Udell, 2003 or Evers, 2001] as are customary in banking, micro-lending relationships, in practice, often show the following **distinctive features** (in addition to the above mentioned general characteristics):

- Short credit terms – high rates of interest
- Guaranteeing of a follow-on credit with precisely timed payments of interest
- Examination of credit worthiness by visiting the enterprise and intensive personal evaluation of the potential credit user (payment morale, character)
- Preference of personal guarantees as collateral over securities in kind
- Active risk management and customer care

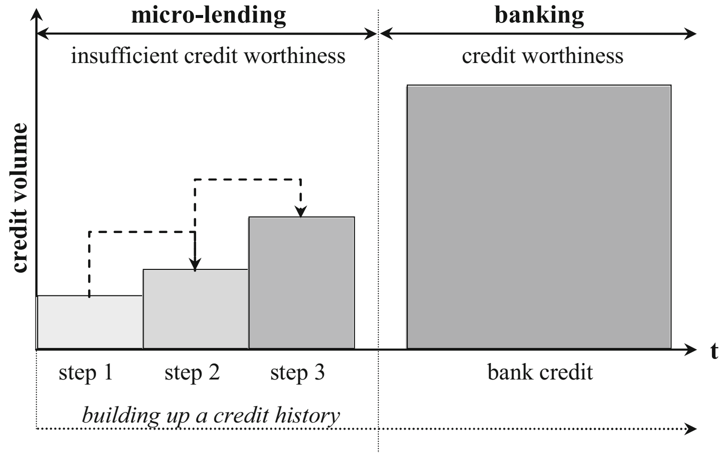
The **examination of credit worthiness** requires a specific procedure to negate the already mentioned difficulties with regard to available business information, which present themselves to very small enterprises. Enterprise visits, incorporating a comprehensive analysis of the entrepreneurial behaviour of the founder(s) as well as of the product quality, replace the otherwise usual analyses of external and internal accounting data. For example, it may happen that the accounting of telephone, water and electricity bills is examined to obtain a proxy indicator of the payment morale of the micro-lending user, given the lack of any credit history of his/her business itself; or the micro-lender tries to find proxies of entrepreneurial capability through personal references of business friends, landlords etc.

So-called **co-signing** may serve as a further tool for reducing information asymmetries. With this tool, the general readiness for granting sureties for the applicant is examined. Business partners of the entrepreneur are recognized as sureties, whilst family members are generally not accepted. The primary objective is not to apply to one's surety in the case of a possible credit loss, but the surety serves in reducing information asymmetries, as it may be assumed that he/she is better informed about the circumstances and competences of the credit user.

Another typical feature of micro-lending is the technique of **stepping.** Whilst within the framework of regular credit checks through banks, potential borrowers are rated on the basis of formal information and data – a reason why the typical target groups of micro-lending do usually not gain sufficient access to credits – micro-lending provides a type of "probation process". If a comparable individualized credit check (as explained above) is passed as an initial hurdle, the credit applicant is first given access to a small initial loan. If this is followed by a punctual amortization, the way for granting a higher credit volume is opened. The total number of such steps within a stepping or step-lending process is preset by each individual micro-lender or his/her credit programme. Such an approach allows the credit-user to build up a positive credit history. A possible and important aim of micro-lending is therefore the "transformation" of the micro-lendee into a normal credit client of a regular bank. Or, in other words, through the utilization of the tools of micro-lending, a previously credit-unworthy person can become a credit-worthy person [Evers (2001)].

Illustration 6-13 shows this relationship graphically.

***Illustration 6-13:*** *Transformation function of micro-lending*




**Monitoring of the Micro-lending Relationship**

Within the context of micro-lending, the granting of credit constitutes the core of the financing contract. However, this form of credit relationship is also subject to specific requirements as regards the continuing relationship with the micro-lendee. **Auxiliary services** are offered to the credit-user, such as, for example, *consulting support for his/her* *enterprise and business training measures.* Especially in the case of a negative enterprise development, this function becomes important.

Through a *continuous* **monitoring** of the credit relationship, the micro-lender is in a position to make direct personal contact with the micro-lendee should problems occur, such as, for instance, the loss of a repayment rate. A so-called credit information system is intended to generate relevant information about the complete process of credit analysis, credit provision and credit repayment.

**Prospects of Micro-lending**

The access to micro-credits presents an often underestimated challenge, especially for very small start-ups. What are the possibilities and limitations of micro-lending?

In principle, the special characteristics of micro-lending indicate that it represents an opportunity which will allow micro-enterprises and small businesses in particular to gain access to debt capital. The overall concept of micro-lending responds to the typical problem areas of start-up enterprises, such as their non-existing credit history or lack of securities. The close relationship between the credit user and the micro-lender should help both partners involved in the credit process to reduce the risk of a failure or credit default.

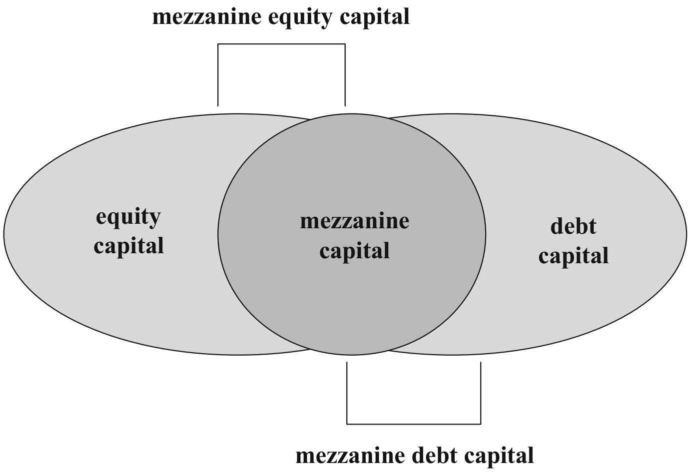
Micro-lending seems tailor-made for the context of developing and emerging countries with little financial regulation and a less-differentiated banking sector. There are also difficulties for small business owners and entrepreneurs in industrialized countries, e.g., in Europe, to obtain loans for their enterprises. However, here existing regulation in the banking sectors of European countries sometimes hamper the use of micro-lending. For example, under the German Banking Act (*Deutsches Kreditwesengesetz*), the access for small and young enterprises to micro-credits is still very much rationed [Koch/Tokarski (2004)]. Typically these limitations exist because of supply-side credit rationing as there are legal restrictions for offering loans and operating a banking business on a commercial basis. Nevertheless, some positive development tendencies can be noted with regard to micro-lending. Numerous initiatives, programmes and co-operations have been formed, which are designed to promote micro-lending across Europe. [See Lorenz (2008) for a recent discussion of micro-lending initiatives in Western Europe.]

# 6.5 Mezzanine Financing

## 6.5.1 Concept and Forms of Mezzanine Financing

Mezzanine capital (mezzanine = Italian for intermediate storey) is a collective concept for a *large number of different financing forms which find their place between equity and debt capital*. More specifically, "the term *mezzanine financing* refers to capital that is between senior debt financing and common stock". [Timmons/Spinelli (2004), p. 485] Mezzanine financing instruments are also called *hybrid financing forms.* Depending on the individual case, typical characteristics of equity or debt capital can be dominant. A clear assignment to equity or debt capital is not possible.

***Illustration 6-14:*** *Mezzanine capital*




The origin of mezzanine capital (debt mezzanine capital and equity mezzanine capital) lies in the United States. There, mezzanine financing in the form of subordinated debt already existed in the 1960s. Also in other countries, mezzanine financing forms are in principle not new. For example, in Germany dormant equity holdings and profit participating rights belong to the classical mezzanine tools. [Bascha/Walz (2007] The concept of mezzanine capital gained importance in Europe in the 1980s, in particular for the financing of buy-in or buy-out transactions, i.e., in larger takeovers of enterprises by external or internal managers.

In financing literature, **characteristic properties** are assigned to mezzanine capital. However, there is no uniform opinion with regard to the characteristics which clearly differentiate it from equity and debt capital. Usually, mezzanine capital is characterized by the following typical properties: [see, e.g., Müller-Känel (2004); Golland (2000)]

- Subordination with regard to other creditors/debt capital providers
- Priority over liable equity
- Higher interest for making the capital available as compared with classical debt capital because of subordination
- Duration of approximately five to ten years to maturity
- Flexibility in the form, prices and conditions of contracts
- Forgoing the provision of collateral

Mezzanine financing instruments are characteristically classified as subordinated debt capital as opposed to ordinary bank loans. If the mezzanine instrument is similar to equity, it can take the function of liable capital in the case of insolvency. Thus banks may assess mezzanine funding as economic equity which can have a positive effect on the rating and credit worthiness of the enterprise. [Marx (1998)] Against the liable equity, mezzanine instruments have, however, a position of priority. A further characteristic in comparison to perpetual equity is the limited maturity of mezzanine capital. For mezzanine forms close to equity capital, the participation in the value increase of the enterprise (e.g., as a dormant equity holding) is characteristic. Mezzanine investors often obtain a stake in future value increases of the enterprise. For example, subscription rights (conversion or option rights) allowing to buy company shares are granted or special contractual payments take place which are coupled to the value increase of the enterprise (equity kicker) [Timmons/Spinelli (2004)]. This is, for example, facilitated by an option through which the mezzanine capital financier obtains the right to acquire shares of the company. For mezzanine financing tools close to debt capital, it is typical that they do not participate in the value increase of the enterprise but include a fixed or variable interest payment (e.g., subordinated loan). In comparison to the classical bank credit, subordinated loans have a higher interest rate due to their subordination factor.

Other typical debt capital characteristics are in particular periodic interest payments, which are independent of the profitability of the enterprise, and the repayment obligation at maturity. Due to the higher risk, higher interest rates are normally demanded compared with classical debt financing. At the same time, it is necessary that the enterprise achieves a stable, sustained cash-flow so that capital requirements can be met. As mezzanine capital has a finite maturity, in comparison to equity capital, the final due date of the commitment is also important in the fund-raising process. Usually, maturities between five and ten years are agreed. In addition, it is characteristic for mezzanine capital that a furnishing of securities is usually not demanded and that contracts can be terminated.

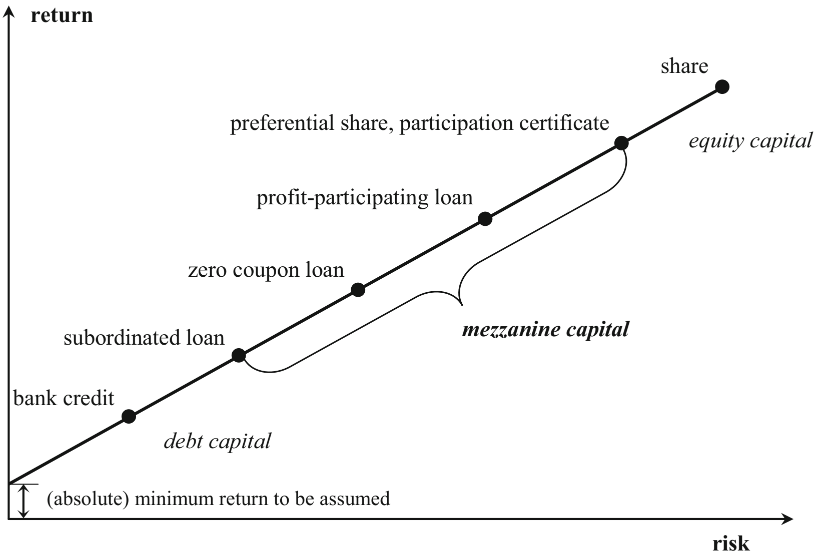
If there is an increased capital requirement, mezzanine financing can serve to close the financing gap between equity and debt capital within the enterprise's capital structure. Thus mezzanine financing instruments mostly complement the capital structure formed by equity and debt capital. If, for example, the level of gearing is already very high so that no further debt can be acquired, equity-similar mezzanine resources can be a suitable financing alternative, which help to improve the enterprise's equity ratio. In the individual case, the concrete financing structure depends, however, above all on the business model and the planned development of the enterprise as well as its prevailing surrounding conditions.

Due to their comparatively high financing risk, mezzanine financing is mostly employed in the growth and maturity phase of an enterprise. Often, mezzanine instruments are used in buy-in/buy-out transactions, i.e., in debt-financed takeovers of enterprises through external or internal managers [Dörscher (2004)].

For **young enterprises**, mezzanine financing tools are of particular interest for *the optimization of their capital structure, growth financing* as well as within *the framework of project financing.* In larger young enterprises qualified to list, mezzanine capital can in principle also be used for pre-financing measures before going public (bridge financing). With the help of equity-like mezzanine tools, the equity position of young enterprises can be strengthened without any changes in the existing ownership situation. At the same time this may allow to take on additional debt in order to reduce overall capital costs. Mezzanine capital can in various cases be advantageous for young enterprises with a high growth potential. Thus mezzanine capital may be suitable if the investment demand is at first very high, perhaps to increase production capacity or to tap new markets, but a stable profit can only be expected at a later date. In situations like this mezzanine capital, unlike venture capital, would have the advantage that mezzanine financiers have less influence on the management of the enterprise.

With a suitable financing solution in mind, further considerations are, however, significant. For example, the anticipated risk/return profile of the investment in the young enterprise must be taken into account. In this context risk is to be understood as an expected adequate rate of return in the future, i.e., the higher the risk, the higher the (risk-adjusted) return expectation will be. The expected return will be dependent on the estimated risk of the investment. For mezzanine investors, this return lies between the expected rates of return for equity and debt capital (ranging between 10 and 20 % per annum, depending on current economic conditions and default risks of the enterprise). Illustration 6-15 shows the relationship between the risk and return expectation of equity, debt and mezzanine financing forms [According to Dörscher/Hinz (2003)].

***Illustration 6-15:*** *Risk/return expectation of equity, debt and mezzanine capital*




Next, the instruments of mezzanine capital are to be briefly addressed.

## 6.5.2 Forms of Mezzanine Financing

A multitude of possible forms can be derived from a combination of the typical characteristics of equity capital and debt capital. In practice, these will be tailored individually to the specific requirements of the enterprise concerned.

**Typical forms of mezzanine capital** are *subordinated loans, partner's loans, dormant partnerships, participating certificates* as well as *convertible bonds and option loans* [Dörscher/Hinz (2003)].

**Subordinated loans** are characterized by the fact that in a case of insolvency they are treated as ranking behind the claims of other creditors (there is usually a subordination agreement, e.g., with banks). However, they are served with priority against the equity shareholders of the enterprise. Although a subordinated loan is based on a credit contract, in practical application it almost resembles equity-like liability characteristics allowing to fine-tune the capital structures of enterprises. The instrument of subordinated loans is particularly popular in the Anglo-American world; in addition, Anglo-American venture capital investors make frequent use of warrant-linked bonds or convertible loans which offer the option to purchase a specified volume of company shares. Elsewhere, in particular in Germany, dormant equity holdings and silent partnerships predominate within the domain of mezzanine instruments [Bascha/Walz (2007)].

**Dormant or silent partnerships** are formed through *a dormant equity holding in the enterprise.* Usually, it is an undisclosed partnership which is not entered into the Register of Companies and does not become evident to the outside world. There may be different forms of silent partnerships:

- those where the silent partner has only a claim on the repayment of the nominal amount of his/her capital contribution and the profit and loss to be allocated to it,
- those where the silent partner also participates in the assets and capital of the enterprise (in addition to its profits and losses) and (in contrast to above) has entrepreneurial participation rights.

The possible forms of **profit participation rights** are numerous and diverse. Often, they are not governed by legal regulations. One can distinguish between *obligation-type* and *investment-like profit participation rights*. This means that, depending on the form of the profit participation certificates, they resemble more commercial papers with fixed interest rates or shares. Profit participation rights can be securitized in the form of a profit participation certificate. In difference to company shares, no owner's rights are granted to the holder of profit participating certificates. Profit participating certificates can be characterized by creditor's rights and a fixed interest payment (debt capital) or by a profit-related interest payment and loss participation (equity). Hybrid forms of participating certificates provide a minimum interest payment as well as a profit-related additional interest.

Conversion and option loans securitize certain special rights in addition to the claim right. In the case of **convertible bonds,** the holder (creditor) has the *right to exchange his/her capital into a certain amount of (new) shares of the emitting enterprise within a certain time period.* With this exchange, the previous creditor becomes a shareholder of the enterprise. **Optional loans** (or callable warrant-linked bonds) refer mostly to the acquisition of shares, but can also allow other rights such as the exchange of a loan. The loan creditor is given, within a certain period of time, the possibility of acquiring, for example, a certain volume of shares at a fixed rate, i.e., shares can be purchased at a pre-specified subscription price. When exercising the option, the holder of the optional bond becomes a shareholder.

There are many possible legal and economic forms, e.g., with regard to terms, securities, interest and repayment modalities. Mezzanine tools can therefore be more appealing in comparison to the traditional financing alternatives. It is advantageous that mezzanine instruments are flexible and can be drawn up and tailored individually to the financing requirements of the young enterprise. In contrast to equity financing, it should however be noted that the running period of mezzanine financing agreements will be limited and will require re-financing as the contract expires. A young enterprise should, therefore, weigh up carefully the enterprise-specific advantages and disadvantages of raising mezzanine financing against relevant alternative forms of equity or debt financing.

## 6.6 Public Enterprise Policy and Start-up Financing

In most cases start-up enterprises acquire funding from informal and institutional segments of capital markets (like those discussed above), but there are also state-aided sources of funding available. Often, these sources are a component of enterprise policies to foster and support the formation of new businesses and innovative entrepreneurship. These policies may occur at different levels, e.g., initiatives by federal governments to promote high-technology entrepreneurship in the context of industry policy-making or new venture support programmes at the regional or local authority level. The individual objectives of these public initiatives are manifold: creation of new jobs, supporting specific groups (e.g., young or female entrepreneurs), improving competitiveness, or fostering regional development. [See Storey (2003), p. 487 for examples of objectives of new venture support programmes in different countries; in addition, there are also instruments and industry policies to foster SMEs in European countries because of their role in contributing to economic growth – see, e.g. for the Slovenian case, Petrin (2004)]

In principle, the rationale for such public interventions evolves around possible *information imperfections* and *capital rationing* with respect to new venture projects and start-up enterprises, in particular in their early phases of development (pre-founding emergence and early seed and start-up financing) [Storey (2003)]. Capital rationing argues that funding for such new enterprises is made insufficiently available by the relevant segments of private capital markets. Similar to general economic policy-making, public funding sources are argued to address possible market failures in the financing of new enterprises. Such anomalies may exist both in equity and debt financing of start-ups. Regarding the latter, venture capital investments after the new economy slump indicate that investment volumes, in particular for seed-stage capital (equity gap), have decreased considerably (see above and, again, www.nvca.org and www.evca.org for the US and European venture capital markets) and investment screening has become more severe [Kollmann/Kuckertz (2004)]. Concerning the former, debt financing of, in particular innovation-oriented, start-ups by institutional lenders like banks is problematic. This is because of:

- the high transaction costs (for screening and monitoring) relative to low credit volumes asked for by small and new enterprises and

- because of the limited upside potential relative to the high default risks of loans to new enterprises [Mason/Stark (2002); Denis (2004)]; however, empirical studies indicate that existing evidence of capital rationing is mixed [Cosh et al. (2005)].

Albeit the above ambiguity concerning possible events of market failure there are numerous public initiatives and funding programmes for new enterprises in countries all over the world. [See Storey (2003) for an overview of different types of public (financial) new venture support policies; see De Meza (1999) for a survey of small and new business support in Europe in particular.] Typical programmes are, for example, loan guarantee schemes, e.g., in the US (Timmons/Spinelli, 2004 and Craig et al., 2007) or in the UK (Riding/Haines, 2001 and Cowling, 2002) which try to alleviate the lack of collateral of new enterprises, direct loans to new enterprises, and public venture capital funds for high-technology start-ups. Often these programmes offer specific terms and conditions, e.g., loans at reduced rates of interest or extended grace periods before redemption.

Public enterprise policy makers argue that there are also information imperfections with regard to small business founders and entrepreneurs and their fund-raising decisions [Johnson et al. (2000) and Koch et al. (2006)]. In particular, it is argued that enterprise founders are often unaware of private (and public) financing alternatives and external sources of information in the start-up process (see also Storey, 2003), suggesting that public enterprise policy should address this problem. Interestingly, a myriad of public funding programmes for new enterprises and SMEs has evolved in Europe, which has led to decreasing transparency. To be able to make use of public funds, a young enterprise thus faces the challenge of selecting a suitable programme. Direct support from public funds takes the form of public equity, debt or mezzanine capital. The most prominent category of public funding are debt instruments (either direct loans or loan guarantees). When examining public support and development programmes in the debt capital sector, the following main criteria should be used:

- Application entitlement for the programme (types of new enterprises and founders; regional focus)
- Intended use of capital
- Maximum financing volumes, *disagio* or discounts, running period
- Conditions (interest rates, fees or other costs)
- Loan redemption modalities
- Securities and release from liability
- Submission of application (house-bank, combination possibilities with other public funding programmes).

## 6.7 Comprehension Test and Recommended Literature

### Comprehension Test

- Define and differentiate the concepts of equity capital, mezzanine capital and debt capital. (6.1.1)
- Discuss the self-feeding and bootstrap approaches as low-budget models of financing and elaborate on their suitability for financing young enterprises. (6.2.1)
- What are the characteristics of the big-money-model? (6.2.2)
- Outline the typical financing phases of young enterprises. (6.2.4)
- Discuss the concept of business angel investments, its importance as well as its advantages and disadvantages for young enterprises. (6.3.3.1)
- Describe a potential investment process of a business angel with its different phases. (6.3.3.2)
- What is meant by the concept of venture capital? (6.3.4.1)
- Discuss structure and methods of a venture capital company. (6.3.4.2)
- Discuss the potential exit possibilities of a venture capital company, also emphasizing the advantages and disadvantages for the young enterprise. (6.3.4.4)
- Work out the potential advantages and disadvantages of the different forms of short-term outside financing for young enterprises. (6.4.2)
- Discuss why supplier credit is considered expensive. Illustrate your explanations with an example. (6.4.2.2)
- List potential securities for a bank loan and discuss the possibilities of furnishing these sources of collateral by young enterprises. (6.4.3.2)
- Discuss the concept of micro-lending and its relevance for young enterprises. (6.4.4)
- Make a survey of typical forms of mezzanine financing. (6.5)

## Recommended Literature

### Financing – standard works

*Brealey, R. A. et al.* (2008): Principles of Corporate Finance, 9th edition, Boston 2008.

*Tirole, J.* (2006): The theory of corporate finance, Princeton 2006.

### Financing and Entrepreneurship

*Berger, A. N./Udel, G. F.* (2003): Small business and debt finance, in: *Acs, Z. J./Audretsch, D. B.* (eds.), Handbook of entrepreneurship research – an interdisciplinary survey and introduction, Boston et al. 2003, pp. 299–330.

*Bhidé, A..* (1999): Bootstrap Finance: the Art of Start-ups, in: *Sahlman, W. A./Stevenson, H. H ./Roberts, M. J./ Bhidé, A.* (eds.) The Entrepreneurial Venture, 2nd issue, 1999, pp. 223–237.

*Denis, D. J.* (2004): Entrepreneurial finance: an overview of the issues and evidence, in: Journal of Corporate Finance, vol. 10, 2004, pp. 301–326.

*Gompers, P./Lerner, J.* (2003): Equity financing, in: *Acs, Z. J./Audretsch, D. B.* (eds.), Handbook of entrepreneurship research – an interdisciplinary survey and introduction, Boston et al. 2003, pp. 267–298.

*Shepherd, D. A./Douglas, E. J.* (1999): Attracting equity investors: positioning, preparing and presenting a business plan, Thousand Oaks et al. 1999.

# 7 Growth and Growth Management

Innovative and, in particular, rapidly growing enterprises generate new jobs, new products and services or even new markets [for the role in industry evolution played by newly emerging populations of firms see, e.g., Aldrich (1999)]. Such enterprises strive to build and improve their market position, increase their turnover and may also achieve rising profits. With this in mind, growing enterprises are not only of central importance in relation to the development of an economy [Carree/Turik (2003)], but also from the microeconomic perspective of business management. Numerous European enterprises, which were founded on the basis of innovations with bright prospects for the future, have exploited the entrepreneurial opportunities their founders perceived and achieved profitable growth, such as, for example, the Dutch-German supplier of biomedical and technological equipment *Qiagen* [Kock (2002)]. Nevertheless, the number of fast growing enterprises (*gazelles*, see below) is demonstrably lower in Europe than in the USA [Twaalfhoven (2005)]. The reasons are numerous and manifold, and their origin lies probably not only in cultural differences. Differentiated empirical research studies are still required to explore the phenomenon of young enterprise growth, especially in the international setting.

The present chapter will focus upon fundamental questions of new enterprise development and growth as well as possible growth strategies of young enterprises, as enterprise growth does not occur automatically [Bhide (2000); Kock (2002)]. In this context, those young enterprises and entrepreneurs that deliberately (or imposed by specific environmental situations) decide in favour of a growth strategy will be of interest. However, even if a young enterprise is aiming at growth, there are still many internal and external factors which can influence this growth negatively or even prevent it. For this reason, essential problem areas of young growing enterprises will be discussed in detail in this final chapter of the book.

## 7.1 Basic Principles

### 7.1.1 Concept of Enterprise Growth

Regarding the question how the term enterprise growth can be defined, the relevant literature does not have a clear answer in the form of a uniform definition. Growth is mostly seen as a purely positive growth within the meaning of a positive change in size [Albach (1965); Aldrich (1999)]. Besides, enterprise growth is generally differenti-



C. K. Volkmann et al., *Entrepreneurship in a European Perspective*
DOI 10.1007/978-3-8349-8752-5_7,

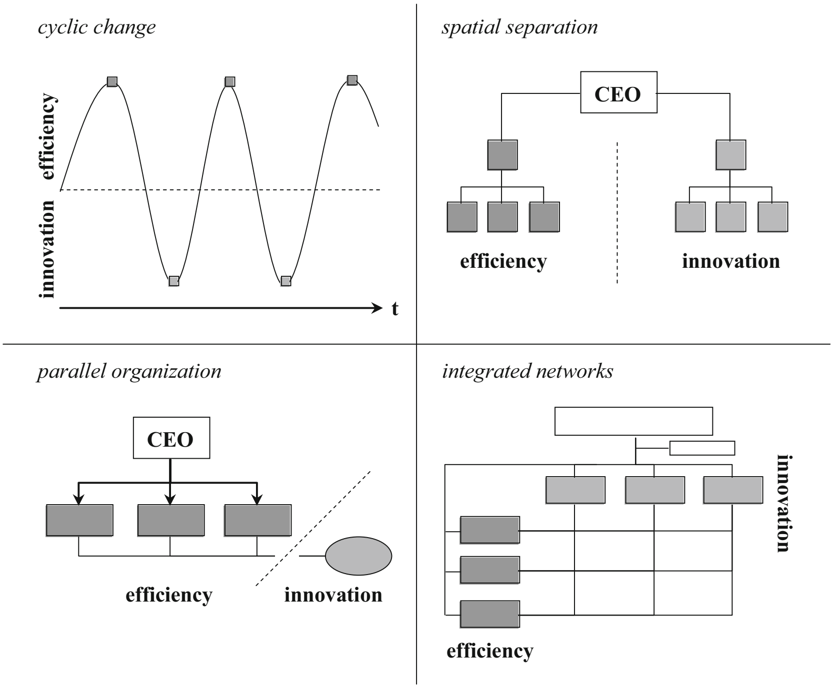
ated into the two forms of **quantitative** and **qualitative growth.** The former may entail growth in terms of *turnovers, profit or number of employees*; the latter may be captured in terms of *job satisfaction, product quality* or the *achievement of objectives from the perspective of the founder*. The condition for the realization of growth is that the young enterprise has a commercially feasible business model and a sufficiently large market potential at its disposal [see also Albach (1986); Hahn (1970); Allen (2003)]. Table 7-1 illustrates that in general different forms of growth can be distinguished on the basis of various criteria [see also Witt (2002) as well as Ahmad/Seymour (2008)].

***Table 7-1:*** *Systematization of forms of growth*

<table>
<tr><th>Criterion</th><th colspan="6">Forms of Growth</th></tr>
<tr><td>Type of growth</td><td colspan="3">quantitative</td><td colspan="3">qualitative</td></tr>
<tr><td>Degree of co-operation</td><td colspan="2">internal</td><td colspan="2">co-operative</td><td colspan="2">external</td></tr>
<tr><td>Geography</td><td colspan="2">ethnocentric</td><td colspan="2">polycentric</td><td colspan="2">geocentric</td></tr>
<tr><td>Value chain</td><td colspan="2">forward integration</td><td colspan="2">diversification</td><td colspan="2">backward integration</td></tr>
<tr><td>Customer group</td><td colspan="3">regular customers</td><td colspan="3">new customers</td></tr>
<tr><td>Distribution channel</td><td colspan="3">direct</td><td colspan="3">indirect</td></tr>
<tr><td>Product development</td><td colspan="2">own development</td><td colspan="2">co-operation</td><td colspan="2">licensing</td></tr>
</table>

A basic challenge in the context of entrepreneurship, as well as for mature organizations, is to increase turnover *and* earnings at the same time. This can be achieved by *combining flexibility (innovation) and efficiency* within the organization and it's strategies and structures. In particular, entrepreneurial and organizational management needs to keep an eye on measures towards organizational cost efficiency to boost earnings as well as on the flexibility of the organization to meet new or changing customer needs so as to spur top-line growth. In theory, and also often in practice, there are discrepancies between achieving flexibility and efficiency simultaneously. It is thus a fundamental growth challenge to manage the balance of these two aspects. With regard to handling this challenge, according to Gomez/Raisch/Rigall (2007), four basic patterns, the *cyclic change, spatial separation, parallel organization* and *integrated networks*, were identified within a longitudinal study. These four patterns may help entrepreneurs and managers to overcome the dilemma between flexibility, which is related to innovation, and efficiency. Illustration 7-1 shows basic structures of (organizational) growth [Gomez/Raisch/Rigall (2007)].

***Illustration 7-1:*** *Basic structures of (organizational) growth*




Within the pattern of **cyclic change**, the organization oscillates or switches between centralized (efficient) and decentralized (innovative/flexible) structures. **Spatial separation** "divides" the organization in an efficiency-oriented and an innovation-oriented part; this can be in organizational or geographical terms. In the **parallel organization** the basic (organizational) structure of efficiency is accompanied with a flexible, innovation-oriented structure. Finally, **integrated networks** combine an efficient and innovative structural elements at the same time within a matrix [Gomez/Raisch/Rigall (2007)]. On the one side, this is an implementation of organizational structures. [See also chapter 5.1] On the other side, it might help entrepreneurs to understand possible divergences between flexibility (innovation) and efficiency. It is important not only to be highly flexible or innovative to achieve organizational growth, but entrepreneurs also have to think about organizational and process efficiency. Only when both aspects are combined in a appropriate way, turnover and earnings can be increased to achieve sustainable enterprise growth.

A fundamental work on the subject of enterprise growth is Penrose (1959). For the more specialized questions why enterprises are heterogeneous and differ in their growth paths and how new enterprises may evolve over time Knyphausen-Aufseß (1993), Agell (2004) and Bhide (2000) provide useful insights.

#### 7.1.1.1 Quantitative Growth

**Quantitative growth** comprises the increase of *measurable* variables. Measurable quantities are, e.g., *sales, turnover, market share, profit* (before taxes), *balance sheet total, capital expenditure, capital* (both equity and debt sources), *number of employees, number of patent applications* or *regional scope.* A survey of the quantitative variables can pose problems in individual cases, as most young enterprises are not subject to disclosure obligations. Also there may be substantial cross-industry heterogeneity in size and growth variables [Curran/Blackburn (2001)]. The most common *variables for measuring* quantitative growth are the *turnover* and *the number of staff* while other indicators are less popular [Ahmad/Seymour (2008)]. However, the question is whether the increase in turnover or number of employees is a meaningful criterion for measuring growth if an enterprise does not simultaneously achieve an increase in profit. Furthermore, the annual profit based on accounting information is also a statistical quantity relating to the past, which does not represent a suitable standard for future profit growth and the potential increase in enterprise value. Essentially, the problems of measuring growth of young enterprises solely in quantitative terms become evident, e.g., when the value of the enterprise is to be assessed. Then it is essential to take into account the factors which will influence future profit and value increase potentials [for the difficulties involved in company valuation in the context of new, growing enterprises see Sanders/Boivie (2004); see also, for example, Kock (2002)].

Within the context of quantitatively measurable enterprise growth, one often talks of the group of *rapidly growing enterprises* without any clear agreement about the meaning of the term “fast or rapidly growing”. As can be seen from Table 7-2, most differentiations for defining fast growing young enterprises have their origin in the USA.

*Table 7-2: Definitions of fast growth*

| Source | Definitions |
|---|---|
| **Eisenhardt/Schoonhoven (1990)** | [*growth markets*]<br>(1) at least $100 million in annual sales, and<br>(2) an average annual growth rate of at least 20 percent |
| **Siegel/Siegel/MacMillan (1993)** | compound annual sales growth of more than 25% for at least three consecutive years |
| **Babson College** [quoted after Timmons (1999)] | sales of at least $1 million and growing in excess of 30 percent per year |
| **National Commission on Entrepreneurship (2001)** | high employment growth (at least 15 percent for five years, or 100 percent in five years) |
| **Kauffman Center** [quoted after Dowling/Drumm (2003)] | increase in sales of at least 30 % p.a.<br>*or*<br>employment growth of at least 20 % in the three preceding years |
| **Barringer/Neubaum/Jones (2005)** | 3-year compound annual growth rate of 80% or higher |

In entrepreneurship studies *fast growing enterprises* are also called **gazelles**, following Birch/Medoff (1994), who contrasted young enterprises into "gazelles and mice". "Mice" are small- and medium-sized enterprises which only employ one or two other persons. In contrast, "gazelles" are fast growing enterprises generating many new jobs, purposefully exploiting entrepreneurial opportunities with substantial growth aspirations of their founders. Such entrepreneurial outcomes, however, may also emerge over the course of time from what has originally been a start-up with non-entrepreneurial growth intentions. [See Jenkins/Johnson (1997) and Bhide (2000) who offer numerous such examples of from what later became US Inc. 100 companies, i.e., enterprises ranking among the largest corporations in the United States.] The market opportunities on which such growth is based may also be recognized and actively constructed by the entrepreneur and taken advantage of deliberately [see also Birch (1987); Birch (1999); Sarasvathy et al. (2003)]. New enterprise development and growth is connected with a process of strategic change and a reorientation of all areas of the enterprise as its growth unfolds. At the same time, attention should be paid to a **strategic fit** between the *enterprise and its resources* as well as *its environment* [Zajac/Kraatz/Bresser /2000)], in that strong or rapid growth in young enterprises usually takes place within a short period of approximately four to five years, constituting substantial challenges for founders tasked with managing this development and organizational change [Timmons/Spinelli (2004)].

The definitions of *gazelles* in entrepreneurship literature are numerous and varying. In their study of the growth of Finnish enterprises Autio/Wallenius/Arenius (1999), for example, define a *gazelle* as an enterprise which can show a turnover growth of at least 50 percent within each of three successive years and achieves at least a turnover of 170,000 Euro in the course of the third year. Yet, (so far) no comprehensive and generally accepted definition of rapidly growing enterprises or *gazelles* has been reached. The various definitions lead to a situation in which different types of fast-growing enterprises are identified within the different populations of new enterprises studied by entrepreneurship researchers [Delmar (1997); Delmar/Davidsson (1998)].

#### 7.1.1.2 Qualitative Growth

**Qualitative growth** can be defined as an increase in the economic vitality of the enterprise with regard to not directly *quantifiable* criteria or indicators. Qualitative growth can, for instance, be defined as the *improvement of the outputs of enterprise activity without a change in enterprise size relative to the enterprise inputs* [Kürpick (1981)]. Examples are improvements of product quality or the quality of customer relations. The qualitative dimension of growth may also include *management competence*, *product or process innovations*, *quality of employees*, as well as *sustainability in enterprise development*. Qualitative growth is, however, on the whole difficult to measure. To capture qualitative growth self-report measures, e.g., relating to the employees, the founders or important external stakeholders (customers, technology partners etc.) may be employed.

### 7.1.2 Systematization of Different Types of Growth

A systematization of growth can be carried out in many different ways. For instance, we can distinguish between the three basic forms of *internal, external* and *co-operative growth.*

#### 7.1.2.1 Internal Growth

**Internal (organic) growth** refers to the *growth within the enterprise through its own internal processes of value creation.* Internal growth forms the starting base for all forms of growth with primary growth usually being internal growth. This is because it secures the capability of the enterprise to survive and represents an economic *raison d'être* in terms of new and efficient resource allocation [Homburg (2000)]. Young enterprises oriented towards growth often secure their survival first through internal growth based on an economically feasible business model. Starting from this basis, external and co-operative growth strategies can then be developed as an extension of the platform of potential for internal growth.

### 7.1.2.2 External Growth

**External growth** refers to growth outside the internal value creation process of an enterprise. Forms of external growth are, for instance, *acquisition, merger* or *forming business trusts.* Possible objectives are the generation of turnover and profit growth. In addition, the *achievement of synergy effects* is often in the foreground (acquisition of complementary resources, efficiency increase through the purchase of combined resources, acquisition of qualified employees, more efficient working processes, spreading of fixed costs/economies of scale). External growth is sometimes used for a *geographical extension of an enterprise*, for *the entry into new markets* as well as for *pursuing a diversification strategy* (horizontal, vertical, lateral or conglomerate).

In principle, numerous examples in various business lines can illustrate external growth. One example from the net-economy is *Amazon* with its acquisitions of, e.g., *dpreview*, *Bookpages, Telebuch* and *Internet Movie Database.* Another example for strong external growth is the network outfitter and supplier of IT infrastructure *Cisco.* The aim of *Cisco* is to become number one or two in all active business fields as a product and market leader. For this purpose, *Cisco* is making continuous acquisitions of (smaller) innovative enterprises, in that the company sees its long-term success in strategic investments and innovations. So far, this strategy seems to have worked successfully, for the last 25 years. The enterprise has developed from a mere start-up to a large enterprise with net sales of approximately 36 billion USD in the 2009 financial year (39.5 billion USD in the 2008 financial year) and over 130 billion USD of market capitalisation. Cisco claims to be market share leader in the sectors of *security, digital video (IPTV), switching (modular/fixed), voice, wireless (LAN), storage (area networks), routing (edge/core/access), networked home and web conferencing* [Cisco (2009); see www.cisco.com for the latest information].

In more recent literature, in particular, the success or the generation of synergy effects in acquisitions or mergers is, however, coming under critical scrutiny. Shulman and Stallkamp, for instance, recommend enterprises to opt for the strategy of “getting bigger by growing smaller” as opposed to a strategy of obtaining fast enterprise growth through acquisition [Shulman/Stallkamp (2004)].

### 7.1.2.3 Co-operative Growth

**Co-operative growth** is a hybrid form of strategy between internal and external growth paths. Co-operative growth is achieved via the *utilization of formal or informal network structures or individual relationships.* The primary **aim** is *the acquisition and employment of complementary resources.* [In the entrepreneurship context this often involves controlling and benefiting from these resources without necessarily owning them; the idea for such resource-efficient behaviour ranges back to Stevenson/Gumpert (1985).] An important condition for the successful realization of co-operation is that each partner can achieve an advantage creating a win-win situation (e.g., through synergies of the exchange of know-how). Motives for co-operation can, for instance, be created through core competencies in basic technologies or key functions. Forms of co-operation are, for example, joint ventures and strategic alliances. Types of co-operation can be differentiated according to the size structure of the partners; from the perspective of a young start-up enterprise there may be co-operation projects with small enterprises (i.e., a similar size structure within the context of entrepreneurship) or with large enterprises (dissimilar size structure). **Classical forms of co-operation** can be listed, for example, in the areas of *licensing* (biotechnology etc.), *research and development*, *outsourcing* (e.g., of production) or in *marketing* [Hutzschenreuter (2001); Welge/Al-Laham (2003)].

Examples for the motives and potential aims of a co-operative growth strategy are summarized in Table 7-3.

***Table 7-3:*** *Motives and potential aims of co-operative growth*

| Growth Motives | Potential Aims |
|---|---|
| **Resource-orientation** | – Technology access<br>– Compensation of limited resources |
| **Time-orientation** | – Shortening of research and development as well as product introduction cycles<br>– Know-how transfer |
| **Cost-orientation** | – Reduction of fixed costs<br>– Exploitation of economies of scope<br>– Generation of a critical enterprise size (e.g., minimum-efficient plant size) |
| **Market-orientation** | – Access to markets<br>– Overcoming market entry barriers<br>– Extension of product range |

### 7.1.3 Selected Growth Models

Both the analytical literature and actual practice contain numerous different models for describing and explaining the growth of enterprises. Well-known approaches are, for example, the growth model of Greiner and the St. Gallen management concept of Bleicher, Pümpin, and Prange. In many cases, however, these individual growth models are based on similar approaches. For a more in-depth understanding of the problems surrounding enterprise growth, the basic concepts for describing and explaining the growth of enterprises will be presented.

According to some authors, one theory alone cannot explain the growth of new, young enterprises in an adequate and satisfying manner [e.g., Gibb/Davies (1990)]. Growth is rather a multi-layered process which is difficult to portray in its total complexity. In the relevant literature, numerous models can be traced back to the original concepts of the **life-cycle** or **phase model** [e.g., the classic model by Churchill/Lewis (1983) trying to conceptualize the growth of new and small enterprises; for the roots of these models (based either upon a developmental or stage perspective) see Aldrich (1999)]. As a rough classification, one can principally distinguish between *evolutionary* and *revolutionary* transformation and growth models. An evolutionary model is accordingly the *basic concept of the life-cycle model (based on the biological analogy of the life of an organism)* and a revolutionary transformation and staged growth model *(e.g., Greiner's growth model).* In addition, **process models** are also described in literature, e.g., the complexity management growth model. Here, potential variables or influencing quantities of growth and their interdependencies within a process-oriented model are described.

#### 7.1.3.1 Life-cycle and Phase Models

In the life-cycle concept, which was borrowed from biology, growth plays a crucial role. First attempts at a life-cycle analysis go back to the sociologist E.G. Tarde (approximately 1900). Further developments of the life-cycle concept *(both in terms of product and company life-cycles)* into a strategic planning tool were carried out by researchers in the 1950s and 1960s such as Dean (1950), Forrester (1959), Patton (1959), Levitt (1965) and Cox (1967). Similarly to the biological life-cycle of living organisms from birth to death, the model comprises typical phases of the *development of a product* from its introduction to its elimination. The complete life-cycle is usually divided into four to six phases which often carry different names. The progressive form of the life-cycle curve is determined by the development of sales revenues of the product in question and its representation in the classical literature corresponds usually to a bell-shaped, normally distributed curve (Gaussian normal distribution). The accumulated sales volume or turnover development is occasionally also represented in alternative forms, such as, for instance, the logistic S-curve.

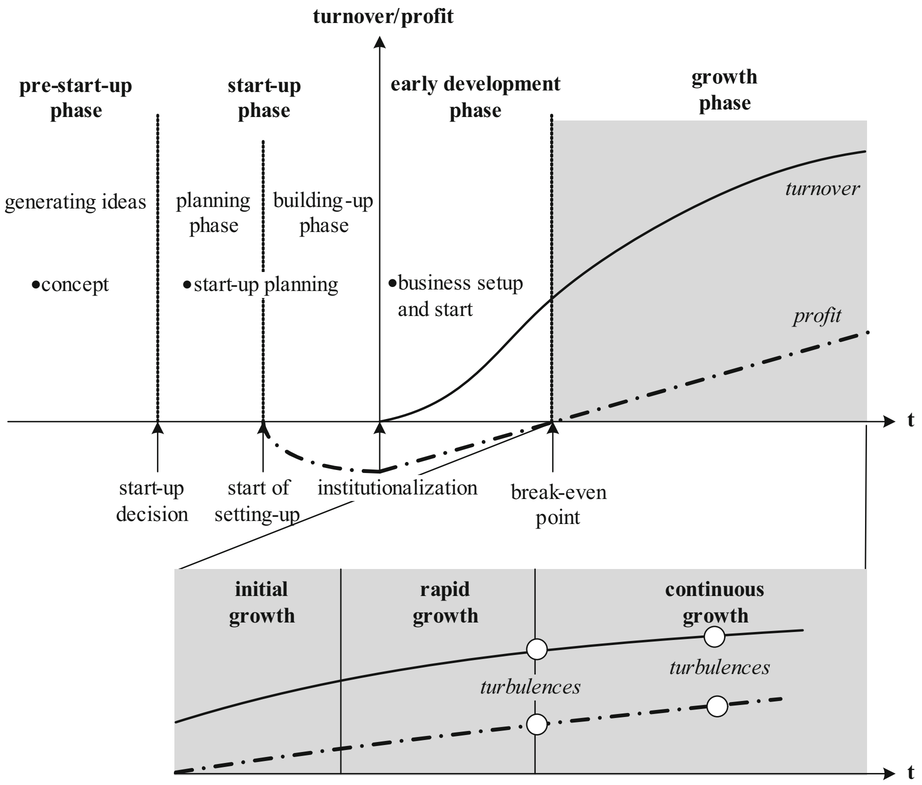
The integrated product life-cycle can be seen as an extension of the classical product life-cycle, which, in addition to the market phase, comprises also the (early) development phase and other part phases [Pfeiffer/Bischof (1974)]. This model is not only used for the classification of products, but also to represent and to explain typical processes in the *development of an enterprise* which can be characterized using various phases (life-cycle models are also called phase models in this context).

The differentiation of the individual phases is carried out in different ways. The differentiating criteria are, for instance, the time (mostly in years), enterprise crises, and enterprise structure or growth rates. In entrepreneurship research and entrepreneurship teaching the life-cycle concept serves as a central, although not always undisputed, model for representing and explaining typical development processes of an enterprise. Reservations against life-cycle concepts stem from the fact that such models assume that "the principles for organizational emergence and growth are similar for all organizations" [Aldrich (1999, 198)]. However, such a rather stereotyped unfolding of new enterprises and organizations according to the genetically driven development of organisms appears debatable [Witt (2003)]. In essence, life-cycle concepts have been accused to presuppose ill-informed "immanent logic, rules, or programs that govern the entity's development" [see Ven/Poole (1995, p. 515)]. However, while such concepts may provide a rather ideal-type explanation of enterprise development at the general level, they still have analytical value for there are indeed identifiable changes in the organizational challenges, structures, and characteristics of growing new enterprises as they evolve over time. Consequently, while not all firms grow to a certain size or travel through all stages (mostly because of the substantial mortality hazard of new ventures), the above typical changes offer orientation for entrepreneurial strategy development [Davidsson (1985)]. In summation, such critical turning points and possible challenges associated with them may be tackled by entrepreneurs and their individual ventures in different ways so that "there are no invariant phases of activity as new firms emerge; instead there are common requirements for development into an economically viable unit, achieved in a variety of ways" [Stam/Garnsey (2005), p. 5].

Illustration 7-2 shows a typical example of an integrated life-cycle concept [based on Zacharias (2001) and Catlin/Matthews (2002)]. The example model entails a range of phases from the phase of pre-founding (organizational emergence), through enterprise birth and early development to the growth phase of a young enterprise. [Another often-cited concept in the entrepreneurship context is the analysis of start-up event sequences in Carter et al. (1996) distinguishing between an organizational gestation phase and new venture infancy and adolescence.]

The growth phase is then again divided into stages of initial, rapid and continuous growth. In the first years after founding the enterprise, turnover growth is less pronounced. This initiating phase, comprising typically five to seven years, may however, diverge significantly from this period, depending on the business line concerned [Hisrich/Peters (2002)]. Against this background, the examples of rapidly growing enterprises, such as, for instance, *Amazon* and *Google*, show that due to the strong exploitation of the internet as a communication and distribution system it has become possible to generate very rapid turnover growth in the initial phase. The subsequent phase, which comprises approximately five years, is characterized by high growth rates of sales volume and turnover. This is followed in a typical case by the stabilization of the growth in the form of a continuous turnover increase. In sum, evolutionary and revolutionary growth phases are connected with each other. Growth can, however, be influenced by various turbulences. Turbulences represent decisive growth thresholds within enterprise development which must be overcome. [The other typical phases of the life-cycle model, i.e., the maturity phase and degeneration phase, are not the focus of observation in the context of young enterprises.]

*Illustration 7-2:* *Integrated life-cycle concept*




Life-cycle models illustrate comprehensibly the *potential* growth of an enterprise. As regards the practical application of the model, the problem is, however, that there are no universally valid criteria for demarcating the phases. Moreover, the adopted Gaussian normal distribution (or S-curve-form) of many life-cycle models is only a theoretical assumption, with the actual development courses of enterprises possibly deviating from this assumption by taking on different forms. The growth of enterprises is usually not a uniform or even growth; it can take on entirely uneven or chaotic features potentially entailing several "bumps and turns" throughout the development process [Aldrich (1999)].

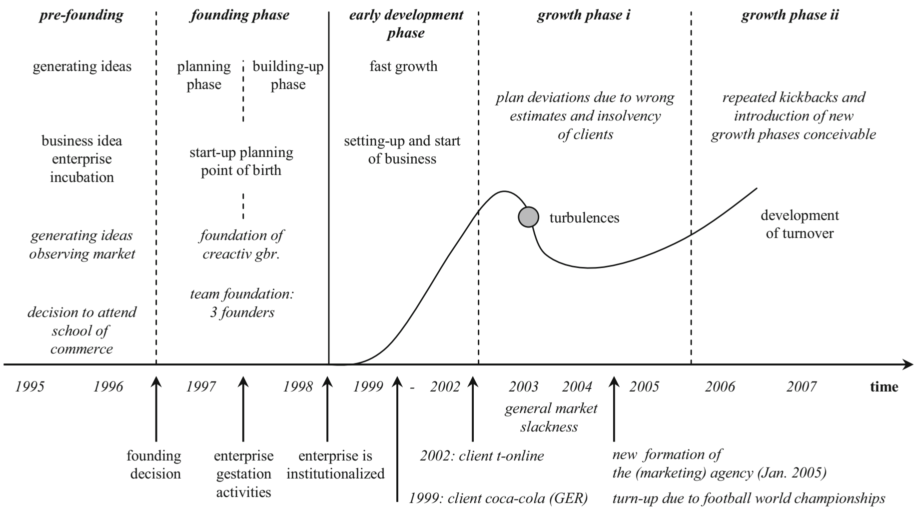
The following case example of the advertising agency *Creactiv* shows the specific development of this enterprise using the integrated life-cycle model.

*Pre-founding phase:* In 1995 and 1996, the three founders of the advertising agency *Creactiv*, Andreas Brandfaß, Bernd Depenbrock and Katja Schettke, generated the idea and assessed the relevant market. The motives for the route to founding their own business were bad experiences as employees, the wish for professional independence and self-realization. *Founding phase:* In 1997, *Creactiv* was founded as a partnership. After the institutionalization of the enterprise (commencement of business, registration of business etc.) the enterprise entered the early development phase. In this *early development phase*, the first sales were achieved in the second stage in the history of the agency. [The above pre-founding firm gestation activities (obtaining licences, opening an office) as well as start-up activities shortly after founding (first sales) are fairly typical for the emergence of new enterprises; see, e.g., the results from the US Panel Study of Entrepreneurial Dynamics.] The enterprise grew little, and with small orders monthly costs could be covered. Thus, at the beginning no profits worth mentioning were made. Then a sudden growth in turnover was achieved by winning *Coca-Cola Deutschland* as a client in 1999. As the agency of *Coca-Cola Deutschland*, *Creactiv* was now in a position to win further clients. Within a short time, *Creactiv* was able to extend their activities all over Germany. Staff was built-up and capital investments were made. One of the founders has described this sudden and fast growth as his greatest challenge, yet he "took his courage in both hands" and met this challenge. The order volume multiplied. As a consequence, the enterprise moved to its present site. In 2002, another large customer was won, *T-Online*.

However, it was not only a question of scoring great successes. Besides successfully acquiring large customers, wrong estimates were made in the production as well as in the sales figures of a CD-ROM for the football-world championship in 2002. The first problems became evident within the *development phase,* as projects were insufficiently covered due to the inability of the clients to pay. This insolvency of some of the clients was unforeseen by the enterprise so that a clear underfunding of the projects had to be compensated. In 2003, a financing gap emerged due to the general slackness of the market. The growth of the enterprise was problematic in spite of acquiring *EDEKA*, a large German retailer, as a customer. The enterprise thus reached a crisis situation, but these turbulences were well employed in a rebound which saw the introduction of a new growth phase. In 2005, the enterprise was founded again as an individual enterprise. An upturn of the business cycle within the advertising industry could be recorded due to the football-world championship in 2006. At present, the enterprise is operating in the areas of *Marketing* (classical advertising, sales promotion, public relations work), S*ports, Promotion & Event* (sports events, promotions, conception and realization of different events), as well as *Media, Design & IT* (graphics, programming, CD-ROMs, internet portals, layout, print).

Illustration 7-3 shows the development of the *Creactiv* Agency.

***Illustration 7-3:*** *Example of enterprise development*

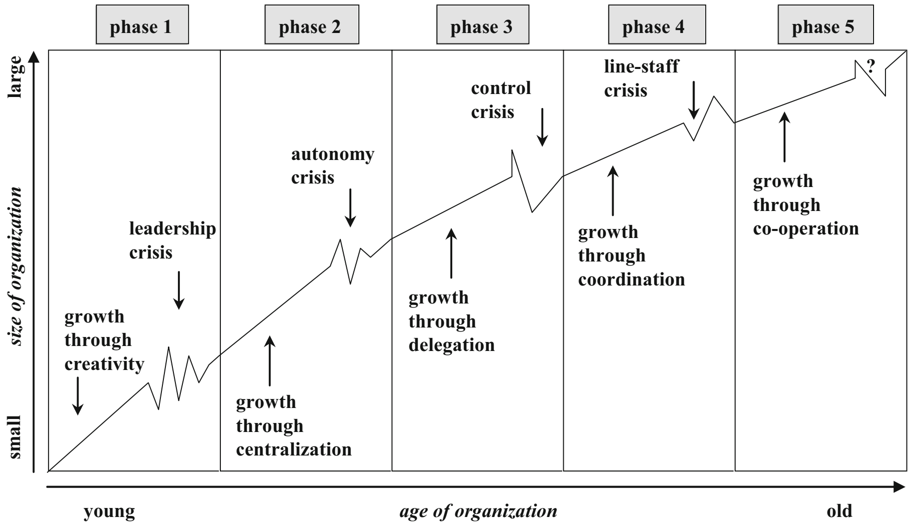



**Greiner's Growth Model**

In the **growth concept according to Greiner** (1972), in its original version, an enterprise runs through *five phases* in its development. Thus, one phase is the result of the preceding phase, and each phase is to be seen as the trigger for the subsequent phase. A characteristic feature of this model is the succession of periods of growth and subsequent growth crises [for a discussion and improvement of the original model see Greiner (1998)]. Within these crises and their resolution, the model captures potential room for managerial agency of entrepreneurs or managers to address and master the different crises and initiate organizational change at certain turning points in enterprise development [Aldrich (1999); also cf. Stam/Garnsey (2005)].

Illustration 7-4 shows the growth concept according to Greiner.

*Illustration 7-4:* *Growth concept according to Greiner*




*Phase 1*

The first phase of enterprise development is characterized by growth through creativity based on the rather informal organization of young enterprises. Flat (or even no hierarchies at all) and unstructured internal operations predominate. Competencies are sometimes not clearly demarcated. This creative growth is followed by a leadership crisis as the enterprise grows to a more complex size.

*Phase 2*

The leadership crisis can be overcome by centralization. Given the strongly increasing growth in this phase, decision-making as well as efficiency and coordination problems are solved by a centralized, strict leadership and division of labour. The enterprise growth is associated with a growth of the individual task areas and duties. A centralized leadership leaves scarcely any space for autonomous actions and decisions by the individual staff members. The result may on the one side be dissatisfaction of the staff and on the other side a likely overload of the centralized top management so that decisions are delayed. This situation leads into what Greiner calls the autonomy crisis.

*Phase 3*

The autonomy crisis can be overcome by the delegation of competencies (decision, instruction and implementation) with growth through delegation as the result. Decentralized decisions require, however, a control of the results and an alignment with the strategic goals of the enterprise. In the growth concept according to Greiner, this will lead to the so-called control crisis.

*Phase 4*
In the fourth phase of enterprise growth, the control crisis can be overcome through coordination by the introduction of expert staff in the role of consultants, and may lead into further growth. These staff members generate information and prepare decisions. They have, however, in principle no decision, instruction and implementation competencies. Following this growth through coordination, there may be a further crisis resulting from conflicts between line management and staff including problems of competence demarcation and other organizational problems.

*Phase 5*
In this phase, the intention is to overcome the "line-staff" crisis with the help of co-operation and the team spirit of all employees. The objective is the generation of future growth through co-operation in multi-functional project groups. This last form of crisis is indicated by Greiner but not further discussed; rather, the designation of the crisis in phase 5 is left open. It is up to the reader to interpret the further course of development himself, and it can be reasonably theoretically assumed that this crisis will lead to a breakdown or to a fundamental reconstruction or revitalization of the enterprise, perhaps triggered off by an innovation crisis.

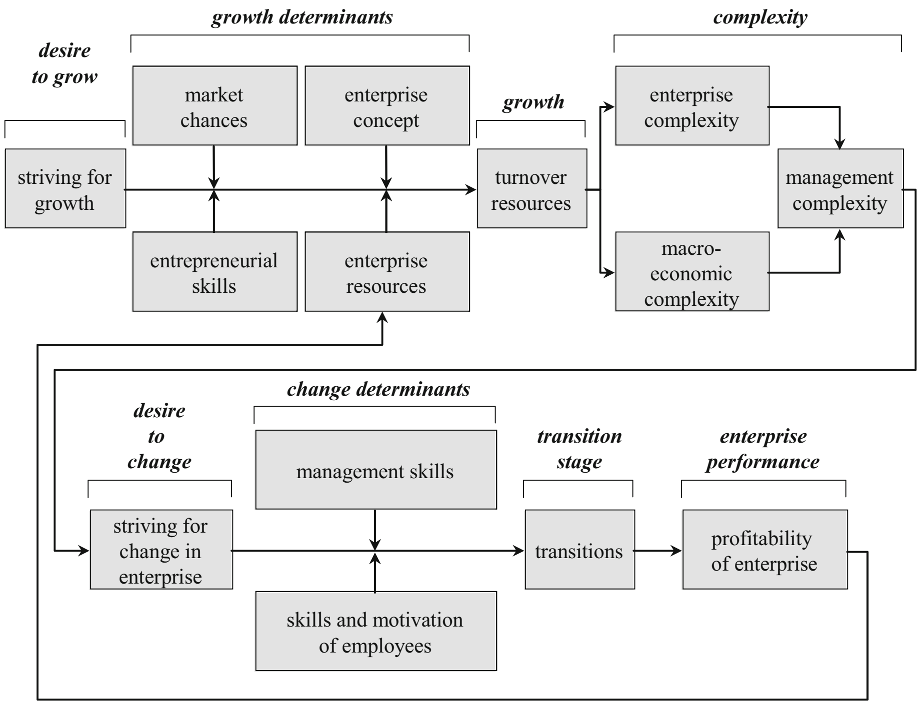
Greiner describes an ideal-type phase model for the development of enterprise growth, however. In reality, enterprises do not necessarily run through the individual phases in this form. It is possible that some phases are skipped, or that they occur in a different sequence. The model of Greiner also essentially refers to internal organizational changes. These do alter in the course of enterprise development, however, the individual crises can be seen not only as causes, but sometimes also as effects of other influences within the development of an enterprise. Each model has its specific advantages and disadvantages. In Greiner's construct, the different growth crises are vividly illustrated, therefore serving as stimulus for reflecting on the growth process and any possible crises. By it, therefore, it may be possible to anticipate potential crises at an early stage and take quick counter-measures when they occur.

### 7.1.3.2 Complexity Management Growth Model

The **complexity management** model of Covin/Slevin (1997) investigates and explains the growth of an enterprise under procedural aspects. The management of enterprise growth is closely connected with *change management*, which deals with the *active construction of change processes in an enterprise regarding strategies, structures, processes and behaviour patterns.* In a similar way, growth management takes place, which concerns the active formation of transformations and management of change in an enterprise. Illustration 7-5 shows the extended complexity-management model from a dynamic, process-oriented perspective revealing the connection between growth management and change management of an enterprise. Starting with striving for initial growth, the *enterprise concept, enterprise resources, entrepreneurial skills of the founders and market op-*

*portunities* are taken into consideration as *growth determinants* in the model. The enterprise concept, in combination with *entrepreneurial skills and the resources of the enterprise,* form a specific individual fit for the enterprise. *External growth determinants* are *market opportunities,* such as, for instance, the age and the structure of the market, and the characteristics of competition or structural gaps in general. As entrepreneurial activity unfolds, the individual growth determinants catalyze or impede the growth of turnover, employees and other resources. Regarding resources, the *availability of funding* is paramount for an enterprise.

***Illustration 7-5:*** *Extended complexity-management model*




The generation of growth is determined by a high *internal and external* **complexity.** *Internal enterprise complexity* interfaces with the *macro-economic complexity* of the business environment as *external complexity.* The determination of a strategic and operative fit between these two dimensions should be achieved by the management or the founder team.

Under conditions of complexity and environment change, the management must perceive a **need for enterprise change** and be motivated to impose it, for growth is associated with a change of existing structures in the enterprise. This process of change is initiated by the management or founder team and is, in each case, dependent on its skills and competencies, such as technical, methodical, social and functional competencies.

Any changes in an enterprise are, however, also influenced by the *employees.* Only if employees show the readiness and motivation for change a successful enterprise growth is possible. The process of change is encouraged by a growth-oriented enterprise culture. Within the context of change, a **transitional stage** occurs, in which measures are implemented, controlled and, if required, adapted. The transitions, in particular, can be critical for the further development of the enterprise. It is possible that a young enterprise has been successfully operating in the market for some years and has already made profits. In the transitional stage, however, it may fall into insolvency, if it has taken too many or too high-rated risks. Ultimately, growth influences positively or negatively the *profitability of the enterprise.* In the case of a successful growth, new resources can be acquired and integrated into the enterprise. The model suggests that in this way a procedural cycle closes, which can again begin with the desire for (further) growth.

## 7.2 Growth, Vision and Targets

### 7.2.1 Growth and Vision

The concept of **vision** can be defined *as an ideal or desirable imaginable state in the indefinite future*. In the hierarchy of goals within strategic management, the corporate vision of an enterprise constitutes the highest level. From this vision, the *overall enterprise concept* and *aims* are derived [Johnson/Scholes (2007)]. In the business management context, vision represents a state of the enterprise in the distant future. This state can be characterized by technology or market leadership, increase in the value of the enterprise, a change of the enterprise culture or by a combination of several characteristics. A true leader and visionary, be it an employed manager or an enterprise founder, moulds the enterprise decisively through the structure of his/her personality and envisioned goals. Ideas and imaginations contribute to elements of corporate vision statements are usually generated on the individual level. Communication of these visionary elements to all enterprise levels is necessary so that they also become important to the employees who can then identify with them. Against the background of the enterprise embedded in a specific environment, the vision can, on the one side, have effects on the enterprise itself and, on the other side, on the different levels of the immediate and wider environment of the enterprise. As an example, a vision of a newly founded enterprise in the biotechnology sector could be:

> *"With our products we increase the memory performance and learning capability of humans."*

In this case, an improvement of the memory performance of potential customers is expressed in the vision statement. This will effect the internal and external enterprise environment. Concrete internal effects, such as, for example, the development of product and process innovations, will contribute to the realization of the vision.

Outside the enterprise, corporate vision statements can also help to break through rigid market structures and existing market entry barriers. Thus the founders of the enterprise *DocMorris* have, for instance, contributed with their vision of an "internet mail-order pharmacy" to changing the rigid structure of the pharmacy market in Germany. This means that drugs and other medicaments can be offered to the customers via internet mail-order in a more convenient and cost-efficient way, which will lead to a stronger competition in this market segment [Opoczynski/Thomsen (2003)].

Vision statements must not always be complicated or technologically founded. The vision of the discount optician *Fielmann*, "to offer fashionable spectacle-frames to all citizens at NHS-prices", was first smiled upon by many competitors. *Fielmann's* growth concept built upon this vision and its entrepreneurial success shows that it would be better if competitors sometimes took visions more seriously and did so at an earlier stage, however simple they appear to be. Today *Fielmann* is the German market leader leaving *Apollo-Optik* far behind. Ninety percent of German citizens know *Fielmann* and approximately 14 million wear their spectacles, among them the former Federal Chancellor Gerhard Schröder [Opoczynski/Thomsen (2003)].

It seems to be important that the employees are also aware of an enterprise's vision and that, in an ideal case, their thinking and acting is aligned to it. The relevance of an organization-wide vision and the attitudes of employees towards this vision can be demonstrated in a brief example of the work of a stonemason:

- Attitude 1:
  "I am working on the production of a stone." (operative thinking)
- Attitude 2:
  "I am working on making a tower." (strategic thinking)
- Attitude 3:
  "I am building a cathedral." (visionary thinking)

This brief example illustrates on the one side the degree of abstraction from an operative to a visionary way of thinking. On the other side, it implies a holistic approach to thinking. The activity of the stonemason has not changed in principle, he produces a stone. However, the specific goal of his work becomes clearer through a visionary way of thinking and the contribution of his work can therefore be placed into a more holistic context. For young enterprises it is important to formulate a vision for just this reason. The importance of a convincing entrepreneurial vision lies particularly in the typical liability of newness and lack of historical performance of new enterprises which casts doubt on the organizational sense-making, future goals and reason for being of new organizational entities; this vagueness can be alleviated by a suitable vision and well-crafted story board of the enterprise's development in the future [Lounsbury/Glynn (2001)]. Overall, an entrepreneurial vision will form the starting basis for strategic action.

Can a vision be developed systematically or does it occur by chance, perhaps through a sudden inspiration of the visionary? This question of the origin of visions cannot be answered unequivocally at this point, although the relevant literature contains some approaches which assume that not only strategies but also a corporate vision can be developed systematically [e.g., Lipton (2003)]. For clearer understanding, the following vision statements of enterprises are listed as examples:

First, two vision statements of enterprises from the biotechnology sector:

> *"With passion, purpose and partnerships, we transform scientific discoveries into advances in human healthcare."* [*biogen idec*]

> *"We will create an innovative, successful pharmaceuticals business with global reach by leveraging our core strengths. We want to build a company being admired as 'best pharma'. Our success will benefit patients and reward employees and owners."* [*Merck Serono*]

The following two vision statements are from the sectors of information and communication technology:

> *"Changing the way we work, live, play, and learn."* [*Cisco*]

> *"Our vision is to be earth's most customer centric company; to build a place where people can come to find and discover anything they might want to buy online."* [*Amazon*]

The vision of the enterprise is also shaped by the vision of the founders or the management. The intention of Jeffrey Preston Bezos, the founder of *Amazon,* was at the beginning to build up the enterprise as the *earth's biggest bookstore.* In the course of the rapid growth of the enterprise, this vision has changed to the *earth's biggest "anything store",* a vision which *Amazon* is now following and strategically realizing. This example shows that the direction of corporate visions is subject to change. The reason for this change can, for instance, lie in new or changed beliefs and attitudes held by the entrepreneur. As visions depend on personalities, this can often lead to radical changes, but also in some cases to serious problems, especially when the leadership at the top of the management changes. For instance, the vision of Edzard Reuter, former board chairman of the (former) *Daimler-Benz AG,* was *the creation of an integrated technology trust.* The core business of the company, car manufacturing, was extended, for example, by the production of electrical equipment for the aerospace sector. The realization of this vision was, however, associated with many strategic as well as operative problems. After Edzard Reuter had left the enterprise, his successor Jürgen Schrempp rejected the former vision and concentrated more on the core business of car manufacturing. His vision was the *creation of a "World-AG"*, i.e., a global market leader in the car industry. Thus, an aggressive external growth was pursued through numerous acquisitions [see chapter 7.4.4.2.1]. The achievement of external growth was, however, also connected with new strategic and operative problems, so that Schrempp could not realize his vision during his time as board chairman of (the former) *Daimler-Chrysler AG*. So Schrempp left *Daimler-Chrysler* and *Chrysler* was sold in 2007/2008 to the financial investor Cerberus. In this context, the car manufacturer concentrated on its core competencies and merely uses a variant of its old name, *Daimler AG*. The future will tell what its new vision to be developed by top management is going to be.

Visions can also be modified through direct influences of the environment or by market developments, as shown by the example of baby food production. After many scandals surrounding contaminated, health-endangering or low-quality baby food, market opportunities arose for organically grown and produced bio-food products. In this context, Georg Hipp developed the vision of producing *baby food from organic, biologically grown raw materials.*

## 7.2.2 Growth Objectives

Ideally, overall corporate objectives **(overall corporate mission)** and leadership principles are derived from a vision [see, e.g., Johnson/Scholes (2007) or the classic Prahalad/Hamel study (1994) for ideas behind and relationships between corporate vision, mission and strategic intent]. They form the *written basis for putting the vision into practice* and contribute to a successful realization through fundamental core statements.

Presented below is an example of Cisco's corporate vision and mission; note that the two are highly interrelated [Cisco (2009)].

Cisco's vision:

> *"Changing the way we work, live, play, and learn."*

Cisco's mission based on its vision:

> *"To shape the future of the Internet by creating unprecedented value and opportunity for our customers, employees, investors and ecosystem partners."*

When deriving **enterprise goals** or corporate objectives, it is intended to concretize and implement the vision. Typical strategic goals are the increase of one's market share by a defined percentage or the increase of shareholder value. From these *strategic* goals, *operative* targets are derived such as, for instance, production or sales targets.

There may also be aims such as the reduction of costs through improvements in procurement or a reduction of the wastage in production. Measuring individual targets can be carried out based on various **indicators,** such as the *return on investment (ROI), the return on equity (ROE)* or the *return on sales (ROS)*. Systematically, growth targets must be assigned to the overall goals of the enterprise, which can be divided into quantitative and qualitative growth targets.

All *targets for the growth of a measurable variable by an absolute or relative amount* can be understood as **quantitative growth targets.** Measurable quantities in this context are, in analogy to the definition of quantitative growth, for instance, *sales, turnover, market share, profits before taxes, balance sheet totals, or the sum of new investments*. Quantitative growth targets are planned objectives in the above listed areas. Examples of quantitative growth targets for young enterprises are the increase of sales by 40 percent (5,000 units), the increase of turnover by 50 percent (200,000 Euro) or the increase of overall profits by 20 percent (20,000 Euro) within a pre-specified period of time. The reduction of (initial) losses from enterprise activities can also be understood as a relative growth.

**Qualitative growth targets** refer to *not directly quantifiable criteria* or indicators. This means that, analogously to qualitative growth, qualitative growth targets can only be measured with difficulty or with increased expense. Concrete qualitative growth targets may include an *improvement of the quality of customer relations, an increase in the motivation of the employees, an improvement in management competencies or a strengthening of the sustainability in enterprise development*. All in all, such qualitative targets, together with an effective strategy for qualitative growth, can contribute to an improved realization of the aspired quantitative growth targets (e.g., an increase in sales volume because of a higher level of motivation of employees).

## 7.3 Growth Analysis

Strategic aspects of growth planning, taking into account the changing conditions within the enterprise and its environment, are regarded as difficult by founders. Often founders see their enterprise as unique and outstanding, transfiguring reality [Szyperski/Nathusius (1999)]. However, the growth management of young enterprises requires realistic changes in the strategies and structures of the enterprise on the basis of well-founded analyses. Before suitable strategy alternatives are developed, target-oriented analyses of growth possibilities and options are necessary. For a systematic approach, various traditional but also innovative analytical tools and methods can be employed.

### 7.3.1 Portfolio Analysis

**Portfolio analysis** is a simple *classical tool of strategic management* which, in its original conception, had been developed for large established enterprises in order to identify and evaluate various business and product sectors in the enterprise. To quote an example, about three quarters of the American top 500 enterprises use this method to analyse their business field portfolio [Kotler (2001)]. The strategic business or product fields are associated with specific opportunities and risks, not only for established but also for young enterprises, and must be recognized and evaluated. In contrast to established enterprises, new enterprises often have only one single, sometimes novel, field of business. In cases in which no or only little growth is aspired to, portfolio concepts cannot be meaningfully employed. If a young enterprise would, however, like to grow in various business fields simultaneously, portfolio analysis can be applied for visualizing and positioning as well as developing strategy alternatives. It must, however, be taken into account that growth is mostly associated with considerable inputs of financial resources, which many young enterprises cannot raise. The employment of portfolio concepts is generally easy to handle and comprehensible, in that the graphical representation is often carried out in the form of a two-dimensional matrix. Portfolio concepts support the strategic thinking in an enterprise and, moreover, they help to encourage the communication of the players involved in the planning process.

Both theoretical literature and concrete practice contain a large number of different portfolio approaches. Among them, the classical **portfolio concepts**, i.e., the *market growth-market share matrix of the Boston Consulting Group* (BCG matrix) and the *market attractiveness-competitive advantage matrix of McKinsey (directional policy matrix),* have gained notice. (In the following, only the BCG matrix will be explained.) [In regards to the concretization of the McKinsey matrix see, e.g., Faulkner (1998).]

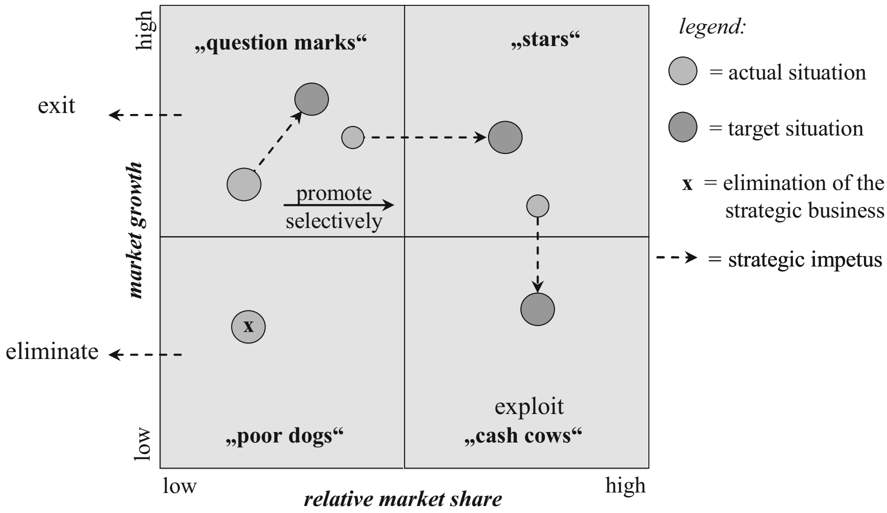
**Market Growth-Market Share Matrix**

The **BCG matrix** was developed as one of the first portfolio concepts and still serves today as a basis for the development of a large number of analytical tools.

Within the framework of the BCG matrix, the two dimensions of relative market share and future market growth are illustrated. The *enterprise perspective* is represented by the **relative market share** which can be derived from the *quotient of the own market share and the market share of the strongest competitor.* The *environmental perspective* is reflected in the **market growth** dimension. High relative market shares indicate a favourable relative cost position, high market growth rates; on the contrary, show a high demand for financial resources.

Illustration 7-6 shows, according to Hedley (1977), an example of a BCG matrix. The assignment of strategic business fields is carried out within four portfolio categories *Question Marks, Stars, Cash Cows, Poor Dogs.* For the individual fields of the matrix and the strategic business or product fields positioned in them, standard strategies (disinvestment, elimination, promotion) can be derived for the following steps. A positioning of the strategic business fields can be made for the current actual situation, the actual portfolio and for the future target situation, the target portfolio. The difference between the two portfolios indicates the future strategic impetus.

***Illustration 7-6:*** *Market growth-market share portfolio*




For new enterprises, the original BCG matrix is usually not suitable, as examples of Cash Cows and Poor Dogs do not yet exist. However, analyses and methods can be derived for young enterprises which want to invest in new business fields or are already actively involved in several business fields. By whatever means, it is important that a visualization of already existing strategic business fields is carried out. One can also try to analyse the strategic business fields of (the leading) competitors and enter them into the matrix to obtain a general view of the market, a visualization that can serve as a *possible* aid for decision-making when formulating growth targets and growth strategies.

In the sector of information and communication technology in particular, for example, the product life-cycles are sometimes very short, a factor which influences directly the strategic business fields and their associated products, which are subject to rapid change. This change should be thus continuously monitored and a repositioning of products and business fields should be carried out. The growth of young enterprises can also occur in such a way that often and within a short time other strategic business fields are added to the original, often single, business field. Internet enterprises, such as *Yahoo!*, *Amazon* and *Google*, were founded in the 1990s, yet they have already, however, achieved a continuous growth as well as a diversification into different strategic business areas. Finally, it should be observed that there may be difficulties to employ the BCG portfolio matrix, depending on the characteristics of the enterprise and the industry it operates in (e.g., it has been found that the matrix is difficult to apply to industrial goods companies in which economies of scope and scale may offer potential for cost superiority). Also, the proxy for market attractiveness (market growth in the matrix) is rather uncertain, recalling from Porter's five forces concept (see chapter 3.1.2.3 above) that there is more to the attractiveness of an industry than its overall growth. [For a critical discussion of the BCG matrix see Faulkner (1998).]

### 7.3.2 ERRC Grid

The method of the ERRC Grid is based on the assumptions of Kim/Mauborgne (2005); also see Kim/Mauborgne (1999) for opening up "blue oceans" which offer entirely novel strategic options [See also chapter 4.2.3.1]. With the aid of the ERRC Grid, it is possible to *open up new markets with creative innovative strategies*. The English acronym "ERRC" stands for ***E****liminate*, ***R****educe*, ***R****aise* and ***C****reate*. For each of these four target areas, individual strategies are developed. The ERRC Grid is also employed to achieve *differentiation as well as lower costs.* At the same time, the grid illustrates potential focussing on certain areas which can lead to an unbalance. The ERRC Grid can, for example, reveal that efforts are concentrated too strongly on the areas of improvement and creation of a product or a service with a resulting increase in the cost structure of the enterprise (a reason for this might be a product with too many superfluous and cost-intensive features and functions). With this analytical method it is possible to visualize such influencing factors in a simple way and thus illustrate implicit assumptions in the process of strategy development.

As a concrete example, Kim/Mauborgne (2005) present an ERRC Grid for the *Cirque du Soleil* (*Sun Circus*). There are no animal acts in the *Cirque du Soleil*, in that the programme concentrates on acrobatics, artistry and original musical compositions. Its concept is closer to that of a variety theatre than a circus. Thus, the *Cirque du Soleil* differs strongly in its concept from the existing circus concepts in North America. According to the North American tradition, the presentation area in a circus consists of three arenas or rings. This concept was rejected by Cirque du Soleil as on the one side the spectator cannot simply concentrate on one ring and has therefore always the feeling of missing something, which leads to an inner tension instead of a state of relaxation. In addition, animals are no longer employed in the *Cirque du Soleil* due to the high cost-factor for medical care, feeding and general upkeep. (A bonus-effect was that the removal of animals from the circus coincided with the newly emerging animal welfare philosophy, as animal acts were increasingly being rejected by the public.) All these factors are no longer contained in the concept of the *Cirque du Soleil* (quadrant: **Eliminate**). Traditional clown acts and acts which were oriented towards simple slapstick humor or sensationalism have also been reduced (quadrant: **Reduce**)**.** The *Cirque du Soleil* is to be perceived by the spectators or customers as a unique venue (quadrant: **Raise**), in that a specific theme associated with a refined, cultured environment has been created for it. Another strategy is backing multiple productions with a presentation of artistic music and dance (quadrant**: Create**). The result is that the concept of the *Cirque du Soleil* has been so successful that a large number of varying programmes are shown at fixed venues, e.g., the shows *O* (Las Vegas), *KÀ* (Las Vegas), *Mystère* (Las Vegas), and *La Nouba* (Orlando). In addition, there are also programmes which go on tour, e.g., *Alegria.*

The listed factors influenced decisively the development of the *Cirque du Soleil*. Illustration 7-7 shows, in accordance with Kim/Mauborgne (2005), the concept of how ERRC was employed via the example of the *Cirque du Soleil*. The explanations show that the ERRC Grid can be applied to many aspects of enterprise planning. First, it can be employed within the business planning for new enterprises in order to generate a potential enterprise concept taking into account and visualizing essential competitors. Second, it can be used in the context of planning future enterprise growth, ideally as an analytical method with which to generate new ideas, create new markets and thus identify and build-up new strategic business fields.

***Illustration 7-7:*** *ERRC Grid*

| | |
|---|---|
| ***Eliminate***<br><br>▪ Star performers<br>▪ Animal shows<br>▪ Aisle concession sales<br>▪ Multiple show arenas | ***Raise***<br><br>▪ Unique venue |
| ***Reduce***<br><br>▪ Fun and humor<br>▪ Thrill and danger | ***Create***<br><br>▪ Theme<br>▪ Refined environment<br>▪ Multiple productions<br>▪ Artistic music and dance |

### 7.3.3 SWOT Analysis

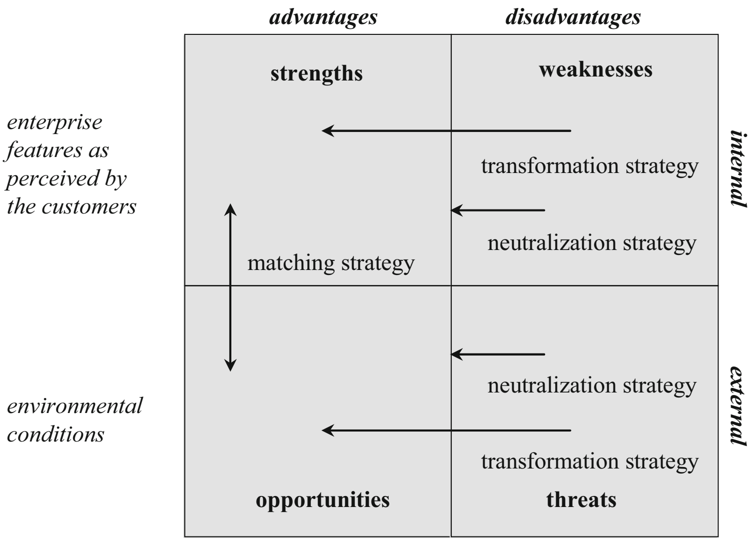
The SWOT analysis method, while useful when generating the business plan (in particular in the analysis of internal and external factors important for the business concept of the venture) can also be productive as a tool for analysing and planning for enterprise growth.

The concept **SWOT** (**S**trengths, **W**eaknesses, **O**pportunities and **T**hreats), aims at clearly contrasting opportunities/risks and strengths/weaknesses of an enterprise to be able to derive different entrepreneurial strategies. Thus the SWOT analysis serves to demarcate the strategic starting position of the enterprise through an *environment analysis* (external) and an *enterprise analysis* (internal). The SWOT analysis is characterized by three conditions. First, a *definition and demarcation of the object of analysis* is carried out. In this way, information of a purely general nature is avoided, and efforts are focussed on one task area. Secondly, an *analysis* of the strategic-starting situation is produced, ideally by an interdisciplinary team. To obtain a market-related analysis, *the perspective of the customer* should be adopted. Strengths/weaknesses as well as opportunities/risks should be identified and analysed.

Three essential strategy types can be distinguished within the framework of the SWOT analysis. First, *matching strategies* can be named, formed by a strength and an opportunity. The strategy is derived from the answer to the question of how a particular strength can be put into practice, taking into account potential external opportunities. Strategies, which can transform weaknesses into strengths or risks into opportunities (or can at least neutralize them), are called *transformation or neutralization strategies*. Finally, a SWOT analysis can also form the basis for evaluating the long-term sustainability of alternative strategic options by assessing the potential strengths, weaknesses and external changes relating to them [Jacobs et al. (1998); Homburg (2000)].

The opportunities and risks defined in a SWOT analysis help to determine the attractiveness of market segments from the specific viewpoint of the enterprise; for example, a market segment may be attractive which features substantial barriers to entry for others but which, because of the individual strengths of the enterprise, may be easily contestable for the enterprise itself. Illustration 7-8 shows the strategy types of matching, transformation and neutralization, as well as their direction within the framework of a four-field-matrix. The matrix is composed by the fields of strengths, weaknesses, opportunities and threats which have been assigned to the internal/external dimension as well as to the advantages and disadvantages [Homburg (2000)].

*Illustration 7-8:* *Strategy development through SWOT analysis*



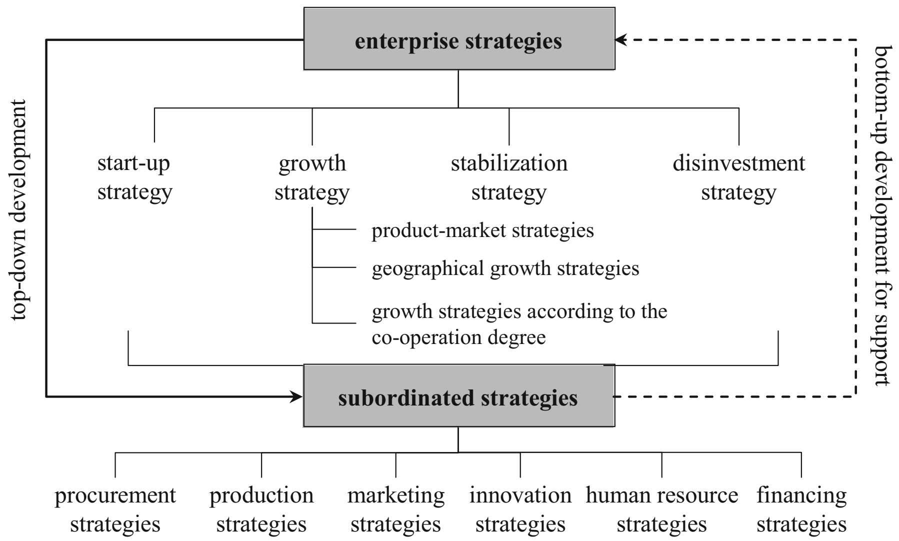

# 7.4 Growth Strategies

## 7.4.1 Concept and Forms of Growth Strategies

**Enterprise strategies** define the *strategic positioning and direction of an enterprise*. In particular, purposeful and target-oriented procedures and alternatives for action are to be fixed in this context. On the basis of the life-cycle concept, the *start-up strategy*, the *growth strategy*, the *stabilization strategy* as well as the *disinvestment strategy* can be distinguished. Growth strategies can be further differentiated according to various criteria. Under the aspect of geographical orientation, local, regional, national, international and global growth strategies can be distinguished. According to the criterion of the degree of co-operation, a classification into *internal, external and co-operative growth strategies* can be made. Within the context of young enterprises, theoretical concepts from strategic management can also be employed to develop and systematize growth strategies, as, for instance, with the product-market matrix developed by Ansoff in the 1960s. In this matrix, product-market strategies are presented which can form a systematic fundament for the development of further growth strategies. Often, the market entry of a young enterprise occurs through the introduction of a new product in an existing market. There exists therefore only *one* strategic business field according to the concept of Ansoff's product-market-combinations. Thus, in the early phases of enterprise development, often a focussing or niche strategy is pursued. If a young enterprise succeeds in generating further financial and personnel resources in the course of its growth process, additional new strategic business fields can be generated and opened-up through product differentiation as a growth strategy [cf. Brush (2001)]. The improved resource base of growing enterprises leads to improved chances for diversification. Through growth a young enterprise can also achieve a significant market position and is perhaps better able to establish new products and production technologies in the market place. Irrespective of which strategies a young enterprises is pursuing, it is fundamentally recommended that *striving for long-term and sustainable enterprise success* takes precedence over *short-term profit maximization*.

Illustration 7-9 gives a survey of typical enterprise strategies based on the life-cycle concept. [According to Bea/Haas (2005)]

***Illustration 7-9:*** *Development process of enterprises and growth strategies*




Prior to founding a new enterprise, a suitable *start-up strategy* must be chosen which should be explained in detail in the business plan. Also, at an early stage the fundamental strategic direction regarding future growth and establishment in the market place must be determined by the enterprise founders or management. This is, in particular, because of the typical imprinting effects of early choices made by entrepreneurs on future enterprise development [Heirman/Clarysse (2005)]. At the same time, other strategy forms based on product-market strategies are to be considered, such as, for instance, the geographical focus of the enterprise or internal, external or co-operative growth strategies. In practice, *growth strategies* of young enterprises may be implemented in the form of innovation or product differentiation strategies. Also, specific subordinated functional strategies, e.g., for procurement, production, marketing and finance, should be developed. However, it is not possible to recommend the choice of a definite overall strategy solution to a young enterprise. In individual start-ups initial strategy decisions will depend on many different internal and external factors and must therefore be decided individually by the founders.

For young enterprises, a continuous growth is often taken as the goal. In reality, the development of growth is not continuous or evolutionary, but often discontinuous and revolutionary [Stam/Garnsey (2005)]. This presents a special challenge for a young enterprise from the point of view of stabilization, in particular in phases of rapid growth [Timmons/Spinelli (2004)]. Up to a certain degree, enterprise growth is necessary to generate a *critical mass* (e.g., a threshold number of users of a new internet platform or a minimum number of reference customers to win the support of investors). In the further course of enterprise development, a *stabilization strategy* could then be implemented in order to secure the achieved market position against the background of competition and requirements for further efficiency gains after a period of strong and often ad hoc thrust of growth. The *choice of the strategy is primarily made by the founders* and often entrepreneurs will go about the process of organizing and strategy development for their businesses in very different ways [Burton (2001)]. Their entrepreneurial vision, aims and motives are crucial determinants for strategy choices. Not all founders aim, however, necessarily at growth. In practice it is typical, for example, for trade businesses to remain small [cf. Davidsson (1991)]. Therefore, founders may consciously decide against growth for various reasons.

However, when taking this decision, the associated advantages and disadvantages must be taken into account. From the point of view of the founder, it could, for example, be advantageous that a small enterprise has a stable organization which is easily managed with regard to the number of employees and which can be directed and controlled by the founder alone. As a possible disadvantage, however, it should be taken into consideration that competitors, who pursue a growth strategy, may achieve improvements in their internal and external resource base and efficiency and thus obtain a competitive advantage.

The *disinvestment strategy* put forth in Illustration 7-9 can be mainly considered as an alternative by large, established enterprises which, for example, are planning a pull-out from business areas that are no longer profitable. In principle, this strategy form is also applicable within the context of young enterprises which have grown large. However, the choice of a disinvestment strategy seems to be rather the exception for young enterprises and is not to be further discussed in our context.

The generation of enterprise strategies is typically carried out in a **top-down-process**, i.e., from the highest strategy level downwards. This method secures homogenous and consistent strategy development with regard to overall vision, corporate objectives and individual measures. However, especially in young enterprises, which have a small size and frequently little formalized structures, this approach can be *supported* or *complemented* by a **bottom-up-process**, often emerging from ad hoc market feedback during the initial establishment process (process from the lowest level upwards). Within the process of strategy development, a "multiple-nucleus" method can therefore be pursued if elements of strategizing occur at several points of the enterprise. The individual planning actions must then, however, be coordinated and brought together. In smaller enterprises this is certainly practicable. A strategy development could also be carried out as in a **mixed planning** approach (with elements of both top-down and bottom-up planning). Accordingly, first top-down-planning would take place which would then be verified and complemented by the information of a bottom-up process.

The application of growth strategies is often associated with the generation of innovations. Both areas are connected with high uncertainty or risks, as it is a case of new products or business fields without a proof of concept in the market place. With growth strategies, often new strategic business fields are generated, in which the enterprise has collected no or only limited experience. The high degree of novelty as well as the diversity and complexity of information require an effective resource combination in order to achieve the aspired success in the new strategic business fields. Not only an improved information and communication system is required to cope with rapid growth, but also an organization and leadership system which needs to be adapted continuously to changing conditions of the enterprise and its environment.

### 7.4.2 Product-Market Growth Strategies

The method of product-market combinations as a basis for strategy development was developed by Igor Ansoff. The *strategic direction* relating to *a growth strategy* is formed by the dimensions of the *novelty degree of products* (product) as well as the *novelty degree of the market* (market). Within this context, the dimensions of product and market are further differentiated into *existing (present/old)* and *new.* With regard to the central question of strategy choice it is to be examined whether existing products or new products are to be sold on existing or new markets. Illustration 7-10 shows the four-field-matrix of Ansoff which contains the four specific strategies and associated basic recommendations for action [Ansoff (1965); Ansoff (1966); Johnson/Scholes (2007)]. The four strategy types of the product-market combination are *market penetration (protect/build), market development, product development* as well as *diversification* [Ansoff (1965); Ansoff (1966); Allen (2003)]. These strategy forms can in principle also be considered as alternatives by young enterprises.

***Illustration 7-10:*** *Product-market-combination matrix*

| | markets (target groups) | |
|---|---|---|
| **products** | **old/present** | **new** |
| **old/present** | ***market penetration***<br>▪ sales intensification<br>▪ acquiring new customers<br>▪ crowding out competition<br>▪ increase in market share | ***market development***<br>▪ opening-up of new additional markets<br>▪ new target groups (new segments, new territories, new uses) |
| **new** | ***product development***<br>▪ internal development<br>▪ innovations<br>▪ contract development<br>▪ licences<br>▪ replacement of products | ***diversification***<br>▪ horizontal (neighbouring products)<br>▪ vertical (alongside the value chain; downwards/upwards)<br>▪ lateral (completely new products) |

The strategy of **market penetration** refers to the presently available products of an enterprise which are offered on the present markets. Often these are saturated markets. An increase in the market share can in this situation normally only be achieved by crowding out the competitors (which is why often a mere protection and consolidation of one's own market share is the primary concern). Also, (for established enterprises) sometimes withdrawing from such markets may be advisable as profit margins may decline over time [Johnson/Scholes (2007)]. In such markets with intensive direct competition, acquiring own market share implies a loss of market share by the competitors. The choice of the strategy of market penetration should be analysed with special care by young enterprises and thought through as regards opportunities and risks. New enterprises must first build up high-production capacities to be able to penetrate successfully such mature markets. The risks of market entry are high, as the established competitors can quickly take countermeasures, and in an extreme case a situation of cut-throat competition can arise. However, new enterprises have also managed in the past to successfully enter saturated markets. A classic example is the discount chain *Aldi* which, thanks to a tight cost management combined with creative growth strategies, has shown how saturated markets like the German food retailing sector can be conquered successfully.

**Market development** describes the opening up of new markets with existing products. Market development strategies allow young enterprises to acquire new target groups. A market development approach may be build upon existing or new competencies of the enterprise [Johnson/Scholes (2007)]. An already existing know-how can be transferred to new markets and customer target groups. Such extension of the market can be achieved via regional, national, international or global growth. At the same time, it has to be taken into account that the opening-up of new markets through international and geographical growth does not only involve a transfer of products, knowledge or know-how. An adaptation to the specific features and characteristics of the new customer target-groups in different countries is required (e.g., habits and beliefs of consumers in different cultures). Not every young enterprise will be able to pursue geographical growth employing an internationalization or globalization strategy. These strategy variants must be seen in dependence of the business model as well as the available resources and growth aspirations of the founders.

In the strategy of **product development**, the distribution of a new product takes place in old or present markets. The new products can be own, proprietary innovations or also the utilization of licences for product development. Product innovations can refer to new products or variations and modifications of existing products. At this point, theoretical demarcation problems arise. As regards product differentiation or variation one might object that it is not a new product but essentially an old product with slight improvements. Thus, it would not be a product development strategy in its real sense. The practical use for young enterprises is, however, not the results of systematization but of the application of individual strategy forms. From this perspective, the product development strategy can sometimes represent an advantageous strategy form when a new product is introduced in existing markets. In this context, no further differentiation and analysis of the target group may be necessary. Already existing target group profiles can be employed for the marketing of the new products.

**Diversification** describes, according to the systematization of Ansoff, the combination of new products for new markets. Typical types are horizontal diversification, vertical diversification and lateral diversification [for the different forms of diversifications as paths towards to growth see Allen (2003)]. In **horizontal diversification**, growth is achieved through products in the same level of the value chain (i.e., related or neighbouring products). In this context, an achievement of synergy effects is aimed at, as business experience within the same level of the overall value chain of an industry already exists which can be exploited for the introduction and marketing of similar products. This does, however, not apply to start-up enterprises which offer a new product in a new market. In this case, we are dealing with a market entry strategy and not with a growth strategy. In particular, for new enterprises the introduction of new products in new markets entails substantial challenges because no prior knowledge or blue-print exists (rather than building horizontal diversification on an existing know-how base as in the case of established, large enterprises) [Aldrich/Fiol (1994)]. **Vertical diversification** aims at *extending* the offer of products alongside the value chain of an industry, i.e., in forward or backward integration. For example, in the car industry forward integration has taken place as manufacturers have started to offer consumer loans and other financial services through their own banking institutions. Through vertical diversification, young enterprises can try to achieve growth via a higher level of integration of additional steps of the value chain.

In **lateral diversification,** the growth is generated by completely new products which cannot be seen in any relation to the activities or products offered so far. In all these areas, but in particular in lateral diversification, the required volume of capital expenditure as well as the production and marketing costs are likely to be substantial. The same applies to the level of risk, because of the degree of novelty involved. However, at the same time, offering new products may be associated with considerable commercial prospects in terms of turnover and profits. The choice from the individual strategy types should be made with two aspects in mind which need to be matched:

- the needs of customers and corresponding potential product/service offers and
- the internal resources of the young enterprise.

With regard to the latter it has been argued that the room for resource-based strategizing (i.e., building a business strategy on unique resource advantages) may be limited for new enterprises because they need to build a resource base in the first place [Brush (2001) and also Fallgatter (2002)]. From the outside-in perspective of what the market has to offer, an essential point is to assess the attractiveness of alternative lines of business with regard to achieving sustainable profits.

### 7.4.3 Geographical Growth Strategies

**Geographical growth strategies** can be divided into *ethnocentric growth strategies* (local, regional, national), *polycentric growth strategies* (international) and *geocentric growth strategies* (global). The ethnocentric growth strategy represents in its local, regional and national forms the primary strategy choice for many young enterprises. First, a core market is demarcated and processed by generating market-specific core competencies, with growth then taking place starting from local through regional to national markets. Conversely, ethnocentric growth strategies can form a basis for the realization of further growth strategies, e.g., polycentric or geocentric growth strategies. The polycentric growth strategy is defined as growth through internationalization. The concept of internationalization describes in this context an extension of the activities and processes to several geographical locations or countries. In contrast to globalization, only a selective extension of activities to individual (international) regions or countries takes place. Growth (which extends in principle to all countries through a world-market orientation) can be defined as a geocentric strategy or globalization strategy.

When pursuing a polycentric or geocentric strategy, it is of great importance for achieving sustainable growth to take into account local market characteristics, customer structures, values, norms, formal and informal rules and regulations as well as the legal, technical and economic situation in the diverse target countries. A poly- or geocentric growth strategy can, for instance, be realized through product development or diversification. In this case, any possible politico-legal restrictions of the countries in question are to be considered in advance.

Traditionally it has been argued that internationalization or globalization strategies are more or less exclusively pursued by large, established enterprises growing into global players and less so by new start-up enterprises. This view has been challenged based on the phenomenon of a new type of start-up enterprises – the "born globals". Born globals pursue rapid internationalization almost right at the start when the business is founded. Not surprisingly, the path of these enterprises follow towards developing a multi-national footprint differs significantly from the incremental internationalization approach portrayed in the traditional literature of internationalization processes. For example, born globals strive for a large-scale establishment of a powerful resource base right from the beginning (often backed by substantial capital investments from external venture capital) including investments in IT infrastructure, production capacities, human resources as well as advertising budgets. A considerable capital input is obligatory for born globals in order to be able to manage fast, nation-wide product roll outs and early international expansion. While the market, operational and financial uncertainties are formidable, it should be noted that start-up success sometimes requires such a strategy of rapid expansion in order to exploit temporal windows of opportunity and conquer global market share before competition steps in. [For the phenomenon of born globals, their international evolution and specific characteristics see, e.g., Andersson/Wictor (2003) or Evangelista (2005).]

The achievement of growth through a geographical growth strategy is first of all only a strategic direction referring to a local, regional, national, international or global field of activity. The growth to be achieved via a geographical growth strategy can then be supported by co-operative growth strategies and subsequent measures for their implementation.

### 7.4.4 Growth Strategies according to the Degree of Co-operation

According to the extent or intensity of the co-operation with others, growth strategies can be differentiated into internal, external and co-operative growth strategies. These growth strategies differ in their effects, e.g., with regard to resource needs and utilization or the speed at which the growth can be realized. Thus, the realization of the various growth strategies is also connected with specific advantages and disadvantages. In practice, internal, external and co-operative growth strategies of enterprises are often applied simultaneously or in succession.

#### 7.4.4.1 Internal Growth Strategies

**Internal** or **organic** growth refers to situations where a young enterprise *grows from its own strengths* and therefore with its *own resources.* In this case, sufficient own resources must be available for carrying out internal growth, both from the quantitative and qualitative point of view. If no or insufficient internal resources are available which can be utilized, one can try to generate them by pursuing a co-operative growth strategy (see below).

There are many and diverse forms of internal growth. If a market grows as a whole, a young enterprise can participate in this growth with its specific product advantages through internal growth strategies. Many new enterprises in the software and internet business have used the entrepreneurial opportunity of growing by generating specific product advantages. Established well-known enterprises of today, such as *Apple, Dell, Oracle* and *SAP,* and also a large number of lesser-known small and medium enterprises, have started their development with internal growth before they attempted other forms of growth. However, not only enterprises from the information and communication technology sectors are offered opportunities for internal growth.

In non-technological business lines too, entrepreneurial opportunities for generating internal growth occur repeatedly. One example of success for the realization of a primarily internal growth strategy is the *Starbucks Coffee Company* (*Starbucks*), a supplier of coffee products and specialities. The coffee products are offered in *Starbucks* coffeehouses (*Starbucks* subsidiaries). Besides coffee, the customers can order other drinks as well as light snacks and other products to take away or consume in-house. The coffeehouses are fitted out in various ways, but generally in a modern style, with many offering wireless internet surfing. The following brief history of *Starbucks* shows that the enterprise has pursued primarily an internal growth strategy right from the beginning.

In 1971, *Starbucks* opened its first location in the Pike Place Market of Seattle, USA, still run by the original founders of the enterprise. A decade later, in 1982, Howard Schultz took over the management of the retail trade and marketing at *Starbucks*. Originally the enterprise supplied coffee to up-market restaurants and espresso bars. During a trip to Italy, Schultz recognized the possibility of importing a European coffee culture into the USA. Like many other US-American new businesses, the founding of *Starbucks* illustrates the typical American way of recognizing and exploiting an entrepreneurial opportunity. In 1984, Schultz convinced the original founders of *Starbucks* to test his concept at a new location in the city centre of Seattle. The positive results of this test changed the orientation of the enterprise and with it the whole industry. In 1987, Schultz, together with a group of investors, bought *Starbucks* from the original founders and put his (growth) vision into practice. This was the beginning of an, at first, rapid internal growth.

By 2008, *Starbucks* has reached a size of over 7,087 company-operated stores and 4,081 licensed stores in the US, as well as 1,796 company-operated stores and 2,792 joint venture and licensed stores in 43 countries outside the United States [*Starbucks* (2008); See chapter 7.4.4.3.3 and 7.4.4.3.4 for Joint Venture, Franchising and Licensing procedures]. The company's owners themselves emphasize that (in contrast to *McDonald's*, for instance) they do not primarily pursue a franchise strategy, with their growth being achieved mainly through the direct founding of enterprises and subsidiaries all over the world. In addition, there is the possibility of acquiring a licence from *Starbucks* for operating a *Starbucks* coffee-house, however, these franchises are placed almost exclusively at well-positioned locations and are not easily affordable. Currently, approximately two thirds of the coffee-houses are run by *Starbucks* themselves, one third is run by licensees. Outside the USA, the ratio is reversed, i.e., about one-third of the coffee-houses are run by Starbucks and two-thirds are operated in the form of joint ventures and licences. The internal growth of the company is therefore partly complemented by a co-operative growth strategy, with the strategic initial situation having been formed by a strong organic growth, and then supported by internal growth strategies.

**Internal growth strategies** form the *basis for entrepreneurial activities.* Young enterprises, in particular, often do not have a choice and must realize growth through *focussing on their own strengths as well as their own resources.* The generation of internal or organic growth depends, however, on a number of factors. These include in the first place the **core competencies** and resources of a young enterprise. **Core competencies** refer to the resources and skills of the young enterprise which form a sustained base for achieving competitive advantages and which need to be built over time by entrepreneurs [Lichtenstein/Brush (2001)]. With the uniqueness of the product or service offer, which the competitors would find difficult to imitate, the realization of an internal growth strategy becomes possible. It is therefore important for a young enterprise to develop and nurture own core competencies and to exploit them purposefully to achieve long-term success in the market. Furthermore, it is necessary that the young enterprise has a well-founded business **plan** at its disposal, as an unsystematic approach in the generation of internal growth without a clear direction can lead the young enterprise into chaos.

Organic growth is often a slow progress which requires not only a clear focussing on one's core competencies to be build, but often also patience and persistence from the enterprise founders. The availability of **liquidity** is a fundamental condition for the permanence of an enterprise and, therefore, for the realization of enterprise strategies. To achieve internal growth, liquidity is necessary in many ways, from the development and diversification of a product to the opening-up or extension of markets, hiring of new staff or the introduction of a computer-aided management information system.

If a market grows as a whole, there is the possibility for a young enterprise to participate in this growth with its specific product offer and to thereby increase its sales or generate new sales. The young enterprise can also grow through **product innovation** and so force market growth. However, the products must not only be developed with internal resources, but must also be marketed in order to follow the pure form of an internal growth strategy. In practice, it often occurs that a young enterprise develops a unique product, but the marketing is taken over by a co-operation partner. This is mainly the case when a young enterprise has too few own resources at its disposal. Distribution partnering occurs in particular in industries where initial costs for product development are high and subsequent marketing and distribution is complex and costly, e.g., in biotechnology and pharmaceuticals where young bio-tech start-ups team up with established big pharma companies. In general, by building-up and using a specific network, young enterprises can thus obtain the required resources through individual co-operations with strategic partners. Thus, specific network structures may be set up which are discussed in the chapter on co-operative growth.

Due to the size of their enterprise, co-operation partners for distribution are probably no longer as relevant for *Starbucks* as perhaps for young enterprises. *Starbucks* can, however, be quoted as a concrete case example for carrying out product innovations on the basis of specific core competencies within the context of internal growth strategies. In addition to coffee and espresso specialities, innovative own creations and further developments of existing coffee products are offered, such as frappuccino ice-blended beverages and other iced and ice-cooled coffee variations. In addition, there are seasonal products, e.g., summer and winter drinks, such as a special Christmas coffee. An important feature of the individual products from *Starbucks* is that each product can be adapted to the individual needs and wishes of the customer.

From *Starbucks'* point of view, it is essential to guarantee a high quality of products continuously amidst all this diversity of offers. To be able to secure a high level of quality, special core competencies are required, such as in coffee processing and roasting. The basis of the coffee products, which builds on this core competence, is formed by a broad range of different coffee types and coffee roasting methods. An important additional "ingredient" in the concept of *Starbucks* is the naming of their individual products. Each coffee product has a special name within a product group. As traditional coffee-houses and restaurants do not normally offer such a wide product range, this offers a differentiation advantage over other competitors. In addition, each individual coffee variant is not normally identified with its own name in the traditional coffee-houses. With *Starbucks*, however, this coined-name feature forms part of its marketing concept.

In addition to coffee, Starbucks offers other, complementary and even substitutive products to coffee, such as patisserie products, coco, tea and juices. It was the original intention of Howard Schultz to present *Starbucks* to customers as a philosophy and way of life within the meaning of a coffee culture. To communicate this culture, the customers are also offered merchandising products. Due to the large number of small details which distinguish *Starbucks* from traditional coffee-houses, it has so far been possible to realize internal and also co-operative growth successfully.

The example of *Starbucks* aptly illustrates that internal growth can be achieved through the **opening-up of new markets** or via geographical growth strategies. In this context too, the availability of individual resources is to be taken into account. Sometimes it is simpler and quicker to generate growth externally than would be possible through organic growth. This is valid under the assumption that resources can be acquired more quickly through external growth than it would be possible via an internal growth. An example would be the purchase of patents and production facilities by the acquisition of a complete enterprise as an external growth strategy. However, as a rule, a comprehensive, strong financial resource basis cannot be assumed for young enterprises which would favour an external growth path in preference to internal growth. Rather, young enterprises are characterized by a restricted financial resource base, at least at start-up and during their early development.

Therefore, one should aim to strengthen these financial resources and to generate further internal resources. The concept of *Starbucks* is also targeted at a continued opening-up of new markets, as is reflected in the total number of *Starbucks* coffee-houses. At first, *Starbucks* pursued an ethnocentric growth strategy. The opening-up of the national American market was followed a polycentric and geocentric growth on the international market and, later, a truly global market presence was achieved.

### 7.4.4.2 External Growth Strategies

#### 7.4.4.2.1 Merger and Acquisition

**External growth strategies** are usually pursued by established enterprises and young enterprises in their later growth phases. They manifest themselves in practice mainly in *merger* and *acquisition* strategies. Systematically, mergers and acquisitions are transactions, in which *enterprises change their ownership structure (partly or completely).* An **acquisition** is understood as the *purchase of a legally independent enterprise by another enterprise*. An acquisition must be distinguished from a merger, however. In the case of a **merger,** we are dealing with a *voluntary combination of two previously legally independent enterprises.* The boundary between acquisition and merger are nonetheless fluid. In addition, the Anglo-American term *takeover* and its division into *friendly takeover* and *unfriendly or hostile takeover* have also been adopted by other countries, e.g., Germany.

Through an acquisition, the taken-over enterprise loses its legal independence. The motives of young enterprises for acquisitions are multiple. Fundamentally strategic, financial or personal motives usually play an important role. Individual **motives** can, for instance, be *turnover growth, access to new markets or technologies, utilization of synergy effects* or the *extension of the product and service range.* In many cases, the purchasing enterprise wants to acquire resources which form a meaningful complement to its own resources and are in harmony with the strategic orientation of the enterprise. These resources can be tangible or intangible. For young enterprises important factors in this context are the takeover of new business fields, the experiences and competencies of the management team, the takeover of protected know-how (e.g., patents) but also the takeover of a non-protected know-how such as, for example, operating instructions or special secret recipes for the manufacture of a product (e.g., a special sauce for catering business).

One enterprise that heavily relies on external growth strategies, especially acquisitions, is *Cisco* with its three pillars of innovation that are defined as *build* (internal innovation), *buy* (acquisition strategy), and *partner* (go-to-market/investment strategy). Cisco focuses on acquisitions that capitalize on new technologies and business models. Correspondingly, Cisco's growth strategy is based on identifying and driving market transitions. In this context Cisco's corporate development focuses on acquisitions that help Cisco capture these market transitions. Cisco has a huge track-record in the field of acquisitions. In 2009 (until November) they acquired the *Set-Top Box Business of DVN, ScanSafe, Starent Networks, Tandberg, Tidal Software, Pure Digital Technologies and Richards-Zeta Building Intelligence.* In 2008 they bought *Jabber, PostPath, Pure Networks, DiviTech, Nuova Systems*. And in 2007 they acquired *Securent, Navini Networks, Latigent, Cognio, BroadWare Technologies, SpansLogic, Web Ex Communications, NeoPath Networks, Reactivity, Five Across and IronPort Systems*. That list can be extended throughout the past years. Overall, Cisco is very successful in the application of its external growth strategy, seeking acquisitions that have the potential to reach “multi-billion dollar markets” [Cisco (2009]:

> *“Cisco’s acquisition strategy is best-in-world and we particularly look for acquisitions that capitalize on market disruption through new technologies and new business models”*

This quote reflects a practical implementation of the concept of disruptive technologies against the background of Joseph Schumpeter’s thoughts. [See chapters 1.1.1 and 2.3.2] In particular, instead of considering new, potentially disruptive technologies merely as a threat to business, Cisco has put them in the centre of their growth strategy. While, such technologies may be disruptive “game changers”, on the other hand they also comprise opportunities for new, multi-billion markets that may be tapped by fast-moving enterprises.

Possible advantages of an acquisition or merger are often seen in a quick generation of *fixed costs degression effects* (economies of scale), as well as achieved *synergy effects* (economies of scope) through a new combination of the so-far independent resources of the two enterprises. However, potential disadvantages can also be listed, such as primarily possible acquisition and re-organization costs when merging the business of the two companies. The young enterprise is confronted with the question whether the paid purchasing price corresponds in fact to the fair value of the enterprise which has been taken over. In practice, problems often arise concerning the compatibility of the individual enterprise-specific resources. This can, for instance, happen in the area of information and communication structures and systems if different methods, concepts and software solutions are used in the two enterprises, e.g., different planning systems. In particular, this includes the planning of procurement, logistics, production, finance and accounting systems, controlling, human resources management etc. It is also possible that different software programs, e.g., in the respective research and development areas, are employed which are not compatible. Under these conditions, high integration and subsequent costs can accumulate for the young enterprise.

It is also important in how far the integration of the taken over resources into the organization and culture of the young enterprise is effectively carried out and the acquisition goals are reached. The joining of different enterprise cultures is linked to great challenges for the enterprises involved in the acquisition process. Differences in the **enterprise cultures** manifest themselves mainly in different values, norms, formal and informal rules and regulations of each enterprise. In many cases, it must be assumed that the incompatibility of different enterprise cultures is an essential reason for the fact that the desired advantages, in particular envisioned synergy effects, are not always achieved. Enterprise cultures have normally grown over a certain period of time and developed their own individual manifestations. Therefore, different attitudes to working methods, processes, but also diverging general moral-ethical world-views can be generated. Especially in young enterprises, the enterprise culture can be shaped to a large extent by the founders, and employees may strongly focus on them for founder personalities usually occupy a central position within the enterprise. (Such founders are numerous in business history. Two examples from Germany are Heinz Nixdorf and Max Grundig who, in each case, have successfully led their enterprises as patriarchs over several decades. In both enterprises, the cultures were strongly influenced and shaped by the founders.)

On the basis of an external growth strategy which has been fixed by management, it is first of all important to identify suitable enterprises which are of interest as acquisition or merger targets. An **initial screening and identification process** is therefore required in which possible take-over targets are selected and listed according to their suitability *for the young enterprise (creating a long list and a short list).* Here a market analysis can help to recognize suitable takeover targets. First, internal information about the acquisition or merger object is generated by an initial contact with the target enterprise to ascertain whether they are interested in a sale, followed by a non-disclosure agreement. In this context, it is already important to create first financing concepts for the takeover deal. The generation of information in this phase may be problematic if the target enterprise is, for instance, a competitor.

If the subsequent talks and negotiations with the owners and managers of the target enterprise are positive and a basic agreement about further proceedings can be achieved, concrete preparations for a takeover can be made. As a first step, a fundamental *feasibility study* has to be carried out. Potential *deal-breakers,* e.g., dependencies on clients, suppliers, or pollution burdens, must be identified in this phase. Within this context, an early examination of potential problems for integrating the takeover object in one's organization is also important for the acquisition. A so called due-diligence process and valuation of the enterprise are to be carried out in the next step/phase in order to collect indications for a possible purchasing price [cf., e.g., Bausch (2000) for the use of multiples as a first indication for the enterprise value and its use in the negotiation process]. The negotiations about the planned acquisition or merger are an essential factor, including the calculation of potential synergies. During the deal negotiations, a possible exclusivity should be discussed at an early stage. Within this context, a financing concept must be worked out before signing the contract. [For details on management approaches and instruments used in acquisition and merger transactions see Hölters (2005), Picot (2005), Gaughan (2007).]

#### 7.4.4.2.2 Due Diligence and Enterprise Valuation

**Due diligence** means literally *"necessary care"*. Within the framework of external growth strategies, the due-diligence process assists in the detailed analysis and examination of a potential investment, takeover or merger project. Within this process, a *systematic and comprehensive analysis of the potential takeover target* is carried out. The complete process is usually subdivided into an initial screening and rough analysis with a subsequent in-depth analysis to follow. The basis for a due-diligence procedure is usually a preliminary contract between the potential buying and selling enterprises. For carrying out the due-diligence process, an adequate period of time should be defined in which the buyer is guaranteed access to relevant data and information as well as access to the enterprise and its staff. Within the context of the process, an *investigation into the strengths and weaknesses* of the enterprise and the associated *opportunities and risks (threats)* is carried out. Simultaneously, a basis for the financial valuation of the enterprise is generated. In a due-diligence proceeding, all areas of the enterprise are in principle significant and will be scrutinized in the course of the internal analysis of the target organization and its external environment (external *environmental analysis* and internal *enterprise analysis*).

In the **environmental analysis,** the *structure of the market, competitors and the industry* as well as *the socio-economic, legal and political conditions* are to be analysed. In this investigation, *market data, data from industry associations, extracts of entries into the Company Register, general business databases, articles in journals and newspapers, consultations of auditors, banks, suppliers, customers and competitors* are relevant. In the **enterprise analysis**, the enterprise is investigated with special reference to the areas of *finance, business strategy, legal structure and contracting, organization, environment, personnel, marketing, technology* and *culture.* The importance of the individual areas can however vary, for instance, according to the industry to which the enterprise belongs. It is essential that a careful and systematic examination of the complete enterprise takes place. Relevant are, for example, the *annual balance sheets of the last few years, interviews of key personnel and management* as well as *factory site visits.* Information is collected and evaluated, e.g., *concerning tangible resources* (e.g., plants, equipment, current assets etc.) and *intangible resources* (patents, licences, trademarks etc.) at least for the previous three years.

In the area of **finance**, an analysis of the internal and external accounting procedures in connection with the tax situation and possible pension obligations of the enterprise is performed. In addition, the capital structure and funding strategy of the business will be screened for possible financial risks. The area of business *strategy* reveals the goals and strategies and, above all, the growth potential of the enterprise. Planned strategies must be practicable. Here it is important how and during which period of time planned strategies are to be realized. In the analysis of the law context, legal aspects such as, for example, contracts or unsolved legal disputes or lawsuits are analysed. In this area, a meticulous examination is required, as possible lawsuits represent substantial risks and have a great influence on the later purchasing price. Within the context of the (ecological) *environment*, an assessment of ecological risks and the inherited pollution burden of the enterprise is made, including questions such as whether the production site is free of pollution and not in need of rehabilitation. An important point is the organization. Within the area of *organization*, investigations into the structural and procedural organization as well as possible relationships with other enterprises are performed. An examination of the *employee pool* is, for example, designed to verify the structure and qualification of the personnel as well as of the management team. Within the context of *marketing and distribution,* the current products, patents, licences as well as research and development are scrutinized. In the examination of available *technology*, the information and communication structure as well as type and age of the means of production are assessed. Not to be forgotten, an analysis of the *enterprise culture,* in which primarily an evaluation of the values and standards as well as the ethical attitude of the enterprise is performed. Especially in acquisitions and mergers, the compatibility of the respective enterprise cultures can play a crucial role.

Illustration 7-11 represents the individual sub-domains of the external environmental analysis and of the internal enterprise analysis within the due diligence process.

***Illustration 7-11:*** *Sub-areas of the due-diligence process*

***due diligence***

| | |
|---|---|
| ***external: environmental analysis*** | |
| *environment* | structure, market and industry, macro-environment (socio-economical, ecological, legal and political) |
| ***internal: enterprise analysis*** | |
| *finances* | internal and external accounting system, financing, pensions taxes |
| *strategy* | aims, strategies, growth potential |
| *law* | legal aspects, contracts, pending and potential lawsuits |
| *environment* | environmental risks, pollution burden |
| *organization* | structural and procedural organization, connections with other enterprises |
| *personnel* | structure and characteristics of personnel (qualification; key positions etc.), leadership style |
| *marketing* | products, patents, licences, distribution structure research and development |
| *technology* | type, age and quality of production technologies and equipment, technical analysis |
| *culture* | values, standards, enterprise culture, ethics |

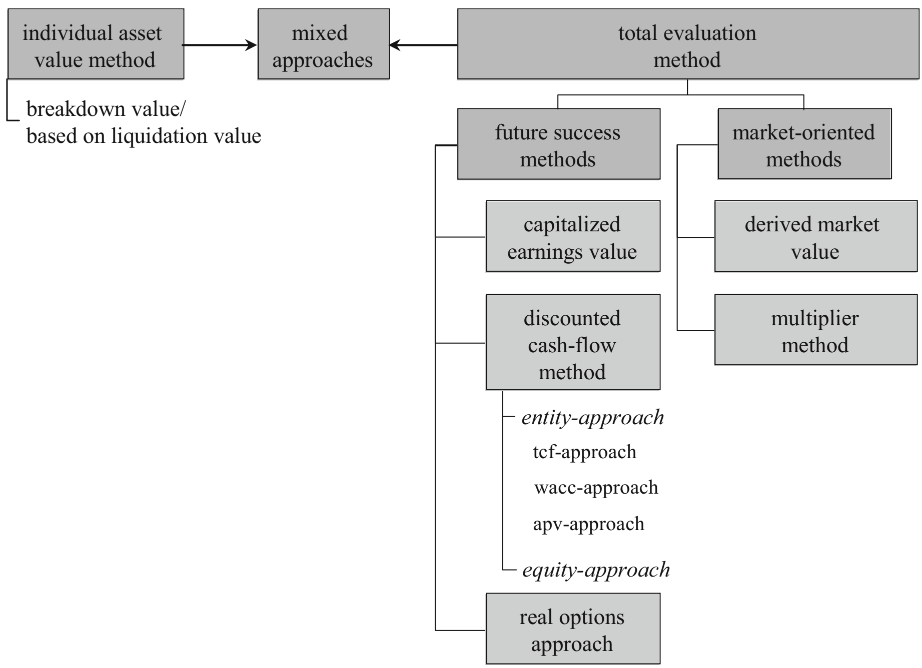
This due-diligence process serves to improve the decision quality when making a purchase or an investment, for it can contribute to a revelation of potential risks. In this way, possible consequential and adaptation costs may be reduced or even avoided altogether after the enterprise purchase. Risks such as current patent disputes or a legal non-compliance with environmental protection law, can, in an extreme case lead to a situation in which the contract negotiations about the purchase of the enterprise are terminated. Or, recognized risks can also serve as a basis for the subsequent contract negotiations relating to possible reductions of the purchasing price or the granting of guarantees by the vendor. Thus, the results of the due-diligence process create the basis for the price negotiations not only with regard to risks, but also in the form of opportunities. The due-diligence process can be carried out by members of the acquiring enterprise or on their behalf by specialists (e.g., auditors, corporate finance consultants, investment bankers).

**Enterprise Valuation**

Irrespective of whether a young or an established enterprise is concerned, it is generally not possible to answer the question of the enterprise value clearly. And because of their lack of a performance history and established business model, the valuation task is even more difficult for new and innovative enterprises than it is for established firms operating in traditional markets [Timmons/Spinelli (2004); Sanders/Boivie (2004); also cf. Carpenter/Petersen (2002)]. (Imagine the challenges to put an exact value on the business of *Google* or *Amazon* at the time of founding.) What would be future sales revenues of these businesses in the net economy and what would be their profitability at all were typical questions at that time. Ultimately, the enterprise value is negotiable on the basis of the price expectations of the seller and the readiness to pay of the buyer, or in other words: *price is what you pay, value is what you get.* The concept of value is only meaningful in connection with a person and depends on the expectations of the individual concerned [Fishburn (1964)]. In spite of this, a systematic and carefully carried out enterprise valuation can form a sound basis for the purchasing price negotiations. Depending on the target object, different methods should be used for carrying out the enterprise evaluation. Importantly, there is *no* agreement in the relevant literature with regard to systematization and application of quantitative methods for this valuation task. Internationally, there is a wide range of different methods and accepted accounting standards for company valuation.

Based on Walter (2004), Illustration 7-12 surveys a systematization of selected quantitative approaches of enterprise valuation [also cf. Copeland et al. (2000) and, for venture capital and private equity financing in particular, Timmons/Spinelli (2004), p. 505].

***Illustration 7-12:*** *Systematization of selected quantitative methods of enterprise valuation*




In connection with the **evaluation of young enterprises,** some of the above valuation approaches will be more easily applicable than others. For example, it is problematic to value a software start-up on the basis of real asset values because this approach ignores the future cash flow and potential profit of the business. The following discussion provides a brief overview of valuation approaches which are typical in the domain of international corporate finance (namely discounted cash-flow methods, real options and multiples). Also the most important challenges in the valuation of new and young enterprises will be addressed briefly. The rationale of the different valuation approaches differ to some extent. Assessing an enterprise based on the (net) value of its assets follows the idea that the value of a company can be derived from its resources and the proceeds from liquidating these assets. In contrast, methods based on earnings values and discounted cash flows argue that the value of an enterprise consists of its (discounted) future success (and the corresponding cash flow and dividend streams). Finally, market-based valuation follows the approach of "mark-to-market". However, not all enterprises are quoted on the stock exchange and thus a market value (i.e., the market capitalization of the company) may not simply be observed. Consequently, the market-oriented valuation of private companies often uses proxies based on peer groups of similar enterprises (e.g., listed companies from the same industry sector or the same size or risk class).

**Discounted Cash Flow Method**

"The discounted cash flow method (DCF) is probably the most commonly used technique to account for the going concern value of a business" [Allen (2003), p. 455]. The **discounted cash flow method** (DCF method) is, like a valuation based on capitalized earnings values, a *multi-period, dynamic approach* [for a good overview of discounted cash flow approaches see Copeland et al. (2000)]. Within the framework of the DCF method, the enterprise value is determined by discounting of future cash flows streams (e.g., annual net cash in- and outflows). In contrast to the earnings values, in which the enterprise value is determined by a discounting of future periodic after-tax profits, the DCF method is a payment-flow oriented approach. In the DCF approach, the actual surpluses of the means of payment, the cash flows, are taken as a decisive quantity and not the annual accounting surpluses. These cash flows can be used in the enterprise to amortize loans, for investments or profit distributions (e.g., dividend payout). For discounting, capital market models are usually applied, such as the capital asset pricing model CAPM [Kasperzak (2001); Bäzner/Timmreck (2004); Nölle (2005); Brealey/Myers (2008); Samuels et al. (1995)].

Specifically, the CAPM is used to determine adequate interest rates for discounting the future cash flows of the enterprise to be evaluated. In order to put an adequate present value on the enterprise all cash flows to be generated in future periods need to be discounted in order to arrive at present values. For this an adequate discount rate has to be used which corresponds to the expected return of equity investors in the enterprise. This expected return is the input provided by the CAPM. In this case, the historical investment return for capital market-related equity is divided into two parts: a risk-free interest rate and a market-risk premium. The market-related equity values are, e.g., measured against stock exchange prices, such as national share indices like the German DAX share index or the Dow Jones Industrial Average DJIA. For the basic interest rate on a risk-free asset ($r_{rf}$) usually the yield of long-term government bonds is used as a proxy. The market-risk premium is determined by subtracting from the return on the stock market ($r_M$) the risk-free interest rate, i.e., ($r_M - r_{rf}$). (But note that the risk of individual equity stocks may differ from the level of overall market risk and thus investors may demand higher returns to compensate for potential additional risk, in the case that the risk of the individual stock is higher than systematic market risk and the corresponding interest return on the market.) To be able to assess this risk more precisely, an individual risk measure is additionally determined, which is measured via the so called beta factor (ß) that captures the covariance of the individual equity stock with the market [Kasperzak (2001); Brandl (2004); Samuels et al. (1995)].

In summation, according to the CAPM, the risk-adequate interest rate on equity ($r_e$) is then calculated using the following basic equation:

$$r_e = r_{rf} + (r_M - r_{rf}) * ß$$

For the determination of a risk-adequate interest rate, the estimation of the beta factor (ß) is therefore of great importance. For *enterprises quoted at the stock exchange,* the determination of ß does not represent a great problem, as historical stock exchange prices can be used. For *enterprises not quoted at the stock exchange* (as it is typical for young enterprises), there is, however, the problem that no stock exchange prices are available. The beta factor is therefore estimated by referring to comparable enterprises which are quoted at the stock exchange (e.g., enterprises operating in the same industry sector or those with a broadly similar size). [For the UK, for example, the London Business School offers market beta value data through its risk-measurement service] On the basis of comparable enterprise data, a potential beta factor can then be estimated. It is to be ensured that the comparison enterprise has at least similar products, a similar business model as well as similar financial and operational risks. To be able to make an evaluation, a precise knowledge and a detailed expertise are required. It may be problematic if, because of an innovative business model of the enterprise to be evaluated, no competitors can be identified who can be considered for the calculation of adequate beta factors [Kasperzak (2001); Bäzner/Timmreck (2004); Brandl (2004)].

The CAPM model is, however, not undisputed in the related theory and in empirical verification, especially with regard to the beta factors, as it has become clear that beta estimations are instable and depend strongly on the period of observation [Rudolf/Witt (2002)]. Therefore, in the valuation of young enterprises estimated return on equity ($r_e$) to be used for the discounting process should be handled with care, for example, running a sensitivity analysis to analyse how the value of the enterprises changes for different $r_e$ rates.

In the relevant literature, the presentation of alternative DCF approaches is also heterogeneous. [The following systematization is based on Ballwieser (2004).] In the DCF method, two main variants are distinguished, the *entity approach (gross method)* and the *equity approach* (net method). The **entity method** (gross method) itself comprises different valuation approaches, namely the *WACC approach,* the *total cash flow approach (TCF approach)* as well as the *APV approach*. [The **equity method** (net method) is not further differentiated. And typically a *flow to equity* figure is used.]

The differences of the individual (entity) approaches lie in the cash flows and capitalization interests used in the calculation [Kasperzak (2001); Bäzner/Timmreck (2004); Ballwieser (2004); Nölle (2005)]. The TCF, WACC and APV approaches differ mainly in the way they take into account the debt level of the enterprise, a factor that is implicitly contained in the TCF and WACC approaches. In the APV approach, it is explicitly calculated as the value of equity and the value of debt are determined separately [Nölle (2005)]. When discussing the entity method, reference will be made here primarily to the WACC and the APV approaches. Table 7-4 shows the differences between the equity and entity approaches [based on Bäzner/Timmreck (2004); also cf. Aders et al. (2000)].

*Table 7-4:* *Variants of DCF method*

| | Equity Approach | Entity Approach | | |
|---|---|---|---|---|
| | | *WACC approach* | *APV approach* | |
| **Basis of valuation** | Flow to equity | Free cash flow | Free cash flow | Tax advantage from debt financing |
| **Cost of capital rate** | cost of equity (based on the existing capital structure of equity and debt) | Weighted average cost of capital (WACC) | cost of equity (based on exclusive equity financing) | cost of debt (e.g., interest on loans) |
| **Result** | Market value of equity | Market value of total capital | Market value of total capital in case of exclusive equity financing | Market value of tax advantage from debt financing |

The calculation of the cash flows can also be made directly or indirectly, and, depending on the method used, the cash flows are calculated differently [See also Rudolf/Witt (2002); Ballwieser (2004); Blaschke (2005)].

*Entity Approach*

Under the **WACC approach** (WACC = weighted average cost of capital), the *enterprise value is determined as the sum of the market values of the enterprise's equity and debt capital (market value of total capital)* on the basis of the values of all payment flows which are due to the equity and debt financier of the business. Within the WACC approach, an evaluation of the enterprise is therefore first carried out from the point of view of all financiers of the enterprise. During this procedure, interest payments to creditors are especially taken into account. Future free cash flows, which will be available to the investors are discounted to the present with the help of the WACC. Typically, in the valuation process a detailed cash-flow projection will be made for the next three to five financial years. However, following the going-concern principle, the enterprise will still have to be assumed to be in business thereafter, generating additional cash flows in the longer-term future. Consequently, these additional cash flows beyond the detailed planning period (e.g., from year six onwards) are to be included as well (the *terminal value* which is to be discounted to the present like the other cash flows). In a second step, the market value of the debt capital is then subtracted from the determined market value of the total capital. In this way, the market value of the equity of the enterprise, i.e., the actual enterprise value, is obtained [Rudolf/Witt (2002); Ballwieser (2004); Bäzner/Timmreck (2004)].

In the WACC approach, the free cash flows serve to pay both equity investors (e.g., via a dividend payout) and creditors (e.g., interest payments on loans). For this reason, the free cash flows are discounted with a mixed interest rate in the form of the weighted average cost of capital (WACC). The WACC represents the market value-weighted average costs of equity and debt capital. Within the framework of the **WACC approach,** a capital-weighted average interest rate between the expected return on equity ($r_e$; e.g., calculated on the basis of the CAPM – see below) and the interest return demanded from creditors ($r_d$) is thus established [Kasperzak (2001); Ballwieser (2004); Füser/Gleißner (2005)]. Weights of the interest rates on equity and equity are to be determined by the amount of equity capital (EC) and debt capital (DC) relative to the enterprise's total capital (TC). The free cash flows are determined first without taking into consideration the tax-deductible interest payments to creditors. Only when discounting the free cash flows is the tax advantage of debt financing taken into account via a corresponding reduction of the capitalization interest rate (WACC) in the form of a tax shield [Löffler (2005); Samuels et al. (1995)].

Thus the tax deductibility of interest payments on borrowed capital (at an interest rate on debt of $r_d$) is taken into account in the WACC approach through a tax shield. This means a reduction of the costs of borrowed capital is included into the discounting factor. The capitalized cash flows are usually after-tax cash flows with a corporate tax rate of s at the enterprise level. In summation, the calculation of the value of the enterprise ($V_e$) based on the WACC approach runs as follows:

$$V_e = \sum_{t=1}^{T} \frac{CF_t * (1-s)}{(1+WACC)^t} + \frac{CF_{T+1} * (1-s)}{WACC * (1+WACC)^T} - DC$$

$$WACC = r_e * \frac{EC}{TC} + r_d * (1-s) * \frac{DC}{TC}$$

$$r_e = r_{rf} + (r_M - r_{rf}) * ß$$

In contrast, if the personal taxes on earnings of the individual shareholders are taken into account in the value determination, then the tax shield on debt may be included in the calculation of the cash flows themselves. In other words, the tax shield on debt financing is then included in the enumerator, i.e., in the determination of the cash flows to be capitalized. The tax calculation is here not carried out on the basis of *earn-*

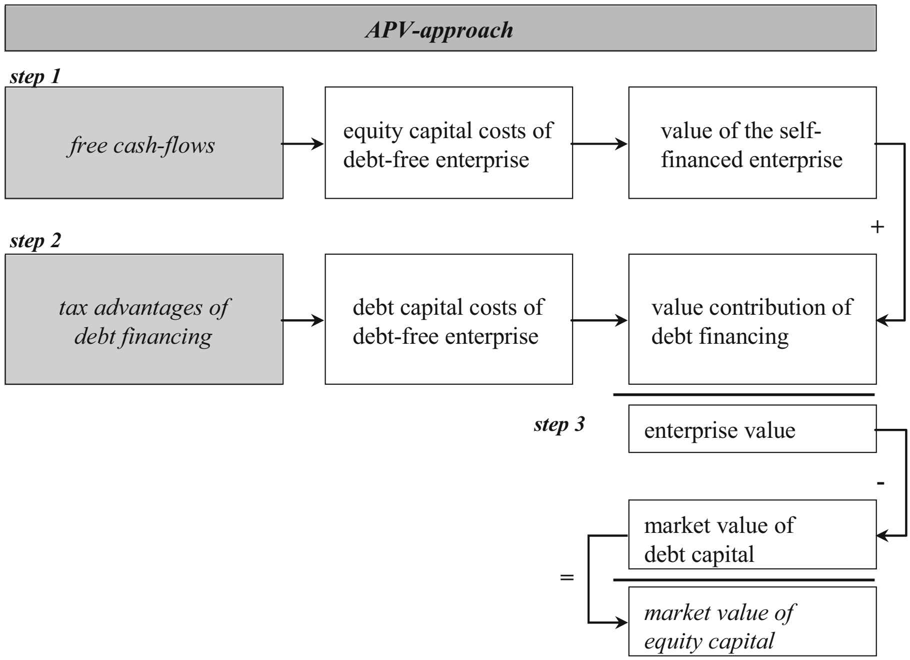
*ings before interest and taxes* (EBIT), but based on the actual basis of taxation after deduction of capital interests on debt. Correspondingly, a tax shield must therefore not be taken into account in the denominator of the WACC [Löffler (2005)]. This alternative method is often called the **total cash flow approach.** The WACC approach differs from the TCF approach only in so far as the tax shield is taken into account in the cash flow determination instead of in the capital costs [Nölle (2005); Löffler (2005)].

The **adjusted present value approach** tries to represent the value of an enterprise's capital separately and to adjust the enterprise value without debt financing accordingly. In the APV approach, the market value of a debt-free enterprise is first determined. For this reason, the free cash flows from a debt-free enterprise are used and discounted with (theoretical) equity costs of a debt-free enterprise (i.e., an enterprise without capital structure risks stemming from gearing). Then, in a separate step, the tax advantage from debt financing, which is to be discounted with the outside capital costs, is added to the above market value of an enterprise funded exclusively by equity.

Overall, the determination of the enterprise value is carried out in three steps with the **APR approach.** In the first step, the value of the enterprise is determined assuming a virtual complete equity financing. In a second step, the value contribution of debt financing is calculated. With this step, any tax shield advantages are also taken into account. Both sources of value together contribute to the enterprise value (including debt capital). In the third step, the market value of debt capital is determined and subtracted from the enterprise value. The result is the value of the equity capital of the enterprise. This approach is well suited for a transparent evaluation of enterprises with variable capital structures because the APV approach allows to separate the effects of a potential tax shield advantage from gearing from the other sources of value [Schulze (2001); Brandl (2004); Nölle (2005].

The basic structure of the APV approach is shown in the following Illustration 7-13.

*Illustration 7-13:* Structure of APV approach




The determination of the costs of equity is carried out using the CAPM. Special beta factors can be obtained, for example, from consulting or auditing companies.

*Equity approach*

Similar to a valuation approach based on capitalized earnings, the equity approach is based on the cash flows of the enterprise available to the shareholders. The differences lie mainly in the derivation of the calculation interest rate and the calculation of taxes. In the **equity approach**, a *direct determination of the market value of the equity capital* is carried out. The expected future cash flows which are to be distributed to the shareholders are discounted with the capitalization interest. The basis of the capitalization interest is formed by the risk-equivalent yield demand of the shareholders themselves [Kasperzak (2001); Ballwieser (2004)], that is, the equity approach focuses on the level of the individual shareholders and the cash flows available to them rather than on the level of the enterprise entity.

*Notes regarding the application of DCF methods to young enterprises*
With regard to young enterprises, the practical application of the DCF procedures sometimes causes problems. First, young enterprises find it problematical to determine future periodic cash flows. The calculation of a discounting rate, especially against the background of the CAPM model, and the determination of an adequate beta factor is not easy. In addition, taxes are also taken into account in the DCF procedures. Making an accurate prognosis within this context can sometimes prove to be quite difficult, as the tax laws may change in the course of time. Generally speaking, the large number of assumptions is a challenge, in particular for young enterprises and inexperienced founders, as these assumptions are not always easy to realize in practice. Due to the numerous variables and associated assumptions, different results can be reached in the process of enterprise assessment. It is thus advisable to seek expert assistance, e.g., from an auditor to support the negotiation process with external investors.

**Multiplier Method**
Because of the difficulties in applying discounted cash flow approaches to the domain of new enterprises, especially those operating in new industry sectors, a wide range of multiples are in use in practice to simplify the valuation task. These multiples are market-oriented, in so far as they either employ stock market values (e.g., the stock price to earnings ratio) or depend on business-related operational indicators such as annual turnover or the number of customers. While (theoretically) the value of an enterprise equals the sum of future cash flows (discounted at an adequate rate of return), the idea of using multiples is that the generation of these cash flows is reflected in certain indicators of business performance (e.g., turnover). Within the **multiplier method,** the (mathematical) *product of an internal enterprise indicator and a numerical multiplier* gives the enterprise value, e.g., "x times annual turnover" [cf. Seppelfricke (1999)]. The quantities used in the evaluation are usually enterprise indicators such as *profit, cash flow* or *turnover.* Theoretically, the number or value of enterprise customers can also serve as a multiplier quantity. Enterprise indicators are derived from calculation in the context of business planning. A specific multiplier (which has to be determined under special conditions) is then applied to the chosen enterprise indicator [Brandl (2004)].

Frequently used **multipliers** are: the *stock price to earnings ratio,* (PE ratio) or the *price to earnings growth ratio* (PEG). These ratios require the company to be listed on the stock exchange, which most young enterprises are not. For the latter, often indicators form the enterprise's business operations are used such as annual profits, turnover and the number of customers or, in the days of the net economy hype, even including the number of clicks on a website. While such indicators may be appealing to be used in practice (because of their simplicity) it should be noted that website clicks and customers do not translate directly into profits and free cash flows to be distributed to shareholders [cf. Sanders/Boivie (2004)].

Technically, when using multiples as enterprise value proxies there is a further challenge to be considered. The mathematical product of the enterprise indicator and the respective multiplier gives the enterprise value. The value of the enterprise is thus decisively determined by the applied multiplier. An *adequate determination and application of the multiplier* is thus important [Pruss et al. (2003)]. Typically, such multipliers (e.g., turnover multiplies) are derived from past experience and performance histories of enterprises from the same industry sector as a yardstick (peer group). The multiplier method allows a quick evaluation of an enterprise and, therefore, particularly for young enterprises not quoted at the stock exchange, the calculation of a potential market price. For enterprises quoted at the stock exchange, over- and under-evaluations can be determined using various methods and multipliers. The multipliers can be directly calculated and applied for young enterprises quoted at the stock exchange. For enterprises not quoted at the stock exchange, the multipliers can be established using comparative values from enterprises in a peer group, as some multipliers require certain values, such as, for example, the share price of an enterprise, which are not available for enterprises not quoted at the stock exchange. To solve this problem, the definition of a specific peer group is required. A **peer group** is a *group of comparable enterprises quoted at the stock exchange* for which the market prices or the share prices as well as other indicators are known, so that relevant multipliers can be derived. When selecting the enterprises of the peer group, attention must be paid to the comparability of the industry and the business model as well as to similar operational and market risks (as with the calculation of beta factors in the CAPM).

The search for suitable comparative companies is difficult. Once the choice is made, the *relevant multiplier* (PE or PEG ratio, turnover etc. – see below) can be determined for *each enterprise.* Then an average based on the arithmetic mean can be formed for each multiplier group from the individual multiplier values. The formation of a median is also possible and in some cases meaningful as a comparative multiplier. When calculating multipliers from the peer group it is important to achieve *comparability* so that all multipliers are calculated for an *equal period of time* and under the *same (methodical) conditions.* If no adequate multipliers can be formed, e.g., because no comparable enterprises were identified, it is possible to fall back on so-called *market multiples.* **Market multiples** are *yardsticks derived* from the practice of enterprise evaluation. However, here too it is necessary to proceed with care, as it is sometimes equally difficult to identify a suitable market multiple.

When attempting to evaluate an innovative enterprise in particular, problems can arise as it may be impossible to form an adequate peer group, and the application of market multiples can also be difficult as no similar business models exist. In this case, one should try to approximate the ideal of a peer group and select, for example, similar business concepts or business lines.

When the multipliers (e.g., PE; PEG; EV/EBIT) have been established, the evaluation can be carried out. When applying the multipliers, it has to be taken into account whether an *enterprise with debts* (entity multiplier) or an *enterprise without debts* (equity multiplier) is assumed. In the case of an **enterprise with debts,** the enterprise value is obtained from the *subtraction of the borrowed capital from the enterprise value calculated by the multiplier* (entity value or gross value). In the case of an **enterprise without debts**, the *value is derived directly from the calculation with the multiplier* (equity value or net value) [Pruss et al. (2003)]. By employing different multipliers, a **valuation range** is obtained for an enterprise (for there is no one definite value that can be derived).

Examples of multipliers are:

*Stock price earnings ratio (PE ratio)*
The **price earnings ratio** (PE) is the *ratio between the (share) stock price* defined as the market capitalization (market value of equity) and the (expected) *profit per share* in a future observation period of an enterprise. To be able to calculate a PE ratio, the enterprise must make a profit. The PE ratio can be calculated as follows:

$$PE = \frac{stock\ price\ per\ share}{profit\ per\ share}$$

*Price earnings-growth ratio (PEG)*
The **price/earnings/growth ratio** (PEG) is derived from the *ratio of PE to an expected profit growth (g).* This ratio can only be calculated if profits are made. It is based on the assumption that a very high current PE ratio can be justified if the profit will grow very strongly in the future [cf. Brearley/Myers (2008)]. If the ratio is 1, the enterprise is evaluated fairly. If the PEG is smaller than 1, the enterprise is basically undervalued, as the PE ratio is lower than the implied growth rate of the enterprise. With a value over 1, it is overvalued or too expensive.

$$PEG = \frac{PE}{g}$$

*Enterprise value/EBIT ratio (EV/EBIT)*
The **enterprise value/EBIT ratio** (EV/EBIT) is the *ratio of the enterprise value* (abbreviated EV) to the *earnings before interest and taxes* (abbreviated EBIT). The enterprise value (EV) is composed of the market value of the equity and debt capital. For young enterprises, multipliers between 5 and 40 are typical. However, other multipliers are also possible, depending on the industry sector the business operates in.

$$EV / EBIT - ratio = \frac{EV}{EBIT}$$

*Enterprise value/EBITDA ratio (EV/EBITDA)*
The **enterprise value/EBITDA-ratio** (EV/EBITDA) is the *ratio of the enterprise value* (abbreviated EV) to the *earnings before interest, taxes, depreciation and amortization* (ab-

breviated EBITDA). The enterprise value (EV) is composed of the market value of the enterprise's equity capital and its borrowed capital.

$$EV\ /\ EBITDA - ratio = \frac{EV}{EBITDA}$$

The aim of the multiplier method is a simple evaluation of the enterprise. The application of this method to an innovative young enterprise is, however, problematic, as it is sometimes difficult to identify comparable enterprises. Also, the method can be seen as static. Quite regularly, there is also the technical problem that young enterprises may have a promising business model but are not yet making any profits (take the example of early-stage biotech or internet start-ups which may need several years to break even). Here, frequently other multipliers like turnover multiples are used in practice. Observe however, that ultimately the value of the enterprise will depend on its future profit available to shareholders (as can be seen in the logic discounted future cash flows approaches). Moreover, "market multiples such as price/ earnings (P/E) ratios are often used by venture capitalists, but their use is speculative at best because they are based on public companies in the industry and on the bet that the new company will go public in three to five years" [Allen (2003), p. 455].

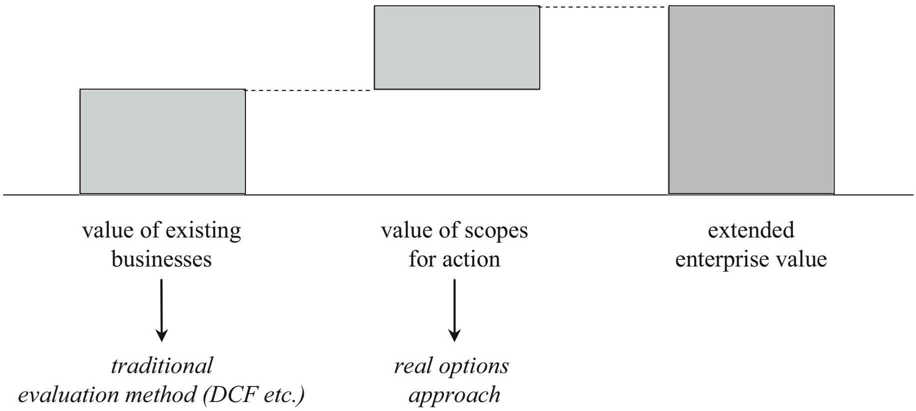
**Real option approach**

The criticism regarding the feasibility of the DCF methods for the evaluation of young enterprises has led to an increased interest in the real option approach during the last few years. In comparison to the traditional methods, **real options** consider the value which arises from the *flexibility of the enterprise* [Adams/Rudolf (2005); Dixit/Pindyck (1995)]. In the real option approach, an enterprise is seen as a flexible entity which continuously reacts to changes in the economic setting. An advantage of the real option approach is the high degree of reality in the representation of the environment on which the entrepreneurial decisions are based [Hommel/Bäcker (2002)].

Myers (1977) sees the value of an enterprise not only in dependence of the value of the existing businesses, but also *taking into account the present value of future growth opportunities* [Myers (1977)]. This is why this approach may be well suited for the valuation of new enterprises whose value is mostly based on future growth and profit potential rather than existing business performance. Accordingly, the value of the enterprise is on the one side composed by assets, the return flows of which will not be influenced by future investment strategy. On the other side, it also consists of assets the return flows of which will only be produced by future investments. This way of looking at things is especially appropriate for young enterprises, as a great proportion of the enterprise value is constituted by the value of the scope for action. For young enterprises, the enterprise value can be seen as an optional right on emerging future markets [Walter (2004)].

Illustration 7-14 shows the theoretical concept of the extended enterprise value according to Walter (2004).

***Illustration 7-14:*** *Extended enterprise value*




Real options represent an *association between an exclusively financial point of view and a focus on the enterprise strategy.* The analogy or correlation between financial and real options consists in similar payout and risk structures. The concept of real options is based on option price theory [e.g., following the Black-Scholes option valuation model; cf. Elton/Gruber (1995)]. An exact, direct transfer is, however, not possible [Walter (2004)]. For the owner, options are connected with the right, but not the obligation, to purchase certain goods or commercial papers during a defined period of time and at a definite price (*call option*), or to sell them (*put option*). This right is secured through a stock purchase warrant. An option is an asymmetrical tool which only entitles to payments under specific environmental conditions. [Hommel/Bäcker (2002); Adams/Rudolf (2005)]

Table 7-5 shows the factors influencing the value of an option [cf. Elton/Gruber (1995); Adam/Rudolf (2005)].

*Table 7-5: Factors influencing the value of options*

| Influencing factor | Value of the purchasing option (call) | Value of the sales option (put) |
|---|---|---|
| Price of basic value increases | Increases | Decreases |
| Higher exercise price of option | Decreases | Increases |
| Volatility of underlying security increases | Increases | Increases |
| Interest rate increases | Increases | Decreases |
| Longer time to expiry of option | Increases | Increases |

The table containing the different influencing factors forms the starting point for a comparative evaluation of different stock purchase warrants using the same basic value. For real options, an evaluation is more difficult. On one side, real options must be identified as such. On the other side, however, it is more problematic to obtain data regarding the basic value of real options than for "classical" options [Adams/Rudolf (2005)].

The transfer of the financial concept of financial options to the real world is called a real option. A real option contains the right, but not the obligation, to carry out a certain transaction for a definite period of time and at definite costs. Options are called real options if the capital value consists of the discounted cash flows of *real assets* and the *value of options* which result from the ownership of these real assets. Note too that real assets also include non physical assets [Walter (2004); Adams/Rudolf (2005)]. Real options differ from financial options in so far as different value drivers can be influenced before exercising options in a way which is advantageous for investors. Options, as well as real options, are characterized by *risk, flexibility* and *irreversibility.* Real options are additionally characterized by an asymmetrical payout-profile. Real options are insofar problematic as the holder of a real option cannot always be clearly identified, in contrast to financial options [Hommel/Bäcker (2002)].

Real options are generated in different ways, e.g., through research projects, new investments or the drawing up of contracts. In the scientific literature, four basic real option types are classified. These are *growth and extension options* (purchase option), *termination and reduction options* (sales option), *postponement options* (future purchase options) and *change options.* **Growth options** represent the possibility of opening up new business fields or markets. **Extension options** refer to already existing projects. As both variants can participate in a positive development, they can be compared to a purchase or call option. **Termination and reduction options** secure the right to terminate an investment or a project at a definite price and/or to sell it. Both options resemble a put option. **Postponement options** offer the possibility of a postponement which may be an advantage in case of a (temporary) risk. The postponement option is comparable with a purchase option. The **change option** is characterized by the right to change between different technologies or procedures [Adams/Rudolf (2005)]. In the relevant literature, the classification is, however, not uniform [see also Trigeorgis (1996); Hommel/Müller (1999); Hahn/Hungenberg (2001)].

The evaluation of the different real option types can be made using various methods. For this purpose, a suitable option pricing procedure is to be chosen. In practice, *analytical* and *lattice methods* are relevant. An example for an analytical procedure is the *Black-Scholes Formula* for evaluating European call and put options. [A European option may be exercised at the date of expiry while an American option may be exercised at any time up to the date of expiration.] Analytical procedures can be employed to supply approximation solutions. These can form the basis for more detailed evaluations. **Lattice methods** are procedures most commonly used in practice for evaluating real options. A well known method is based on the model of Cox/Rubinstein/Ross (1979). This model uses a binomial process and is therefore also called the binomial model [Hommel/Bäcker (2002); Adams/Rudolf (2005)]. [For a detailed discussion of the real option approach, see Elton/Gruber (1995); Hommel/Bäcker (2002); Ernst/Haug/Schmidt (2004); Adams/Rudolf (2005).]

Real options are not only interesting for evaluation. At the same time, they represent a basis for a contemporary management philosophy, e.g., value management [Hommel/Bäcker (2002)].

**Concluding Remarks on the Valuation of Young Enterprises**

It is typical for young enterprises that their *future opportunities and financial prospects* are counter-balanced by a high level of *financial, market and operational risks in the course of enterprise development.* This applies especially to innovative enterprises whose market potential is still difficult to estimate, as well as to fast-growing enterprises whose dynamic growth makes a realistic enterprise valuation still more difficult.

How and according to which criteria can newly founded enterprises or young enterprises then be evaluated?

If no or only few quantitative data are available within the historical context, potential investors evaluate young enterprises in an early phase of development with the aid of qualitative factors [Sanders/Boivie (2004)]. Important to this process are the future prospects of the young enterprise which are usually extensively represented in the business plan. These refer mainly to the following areas [cf. the evaluation criteria for investment screening used by venture capital investors, see chapter 6.3.4.3 above]:

- the (complementary) competencies and experiences of the management or the enterprise founders,

- the business model and its market perspectives,
- the customer potential taking into account the competition as well as
- the usefulness of the product to customers.

Investors then study in detail the business plan. If an investment can, in principle, be considered, an extensive due-diligence process will follow in which intangible values such as rights, licences, patents, management expertise of the founder team, as well as any existing contracts, are examined carefully and in depth. As a last step, the purchasing price reflecting the value of the enterprise is negotiated. In practice, the purchasing price within the framework of acquisitions is also determined in individual cases without the use of professional valuation procedures. In these cases, the entrepreneurs depend on their "gut feeling". An enterprise is then finally worth as much as an entrepreneur and other investors are ready to pay for it.

All said, the pursuance of an external growth strategy for an enterprise is associated with the employment of substantial financial resources. At the same time, the implementation of external growth strategies can be difficult for many young enterprises, whose financial resources are usually too low to be able to pursue an external strategy. To acquire investors also often proves to be difficult for a young enterprise. The availability of financial resources is, however, a necessary condition for the acquisition of additionally required resources. Whether an external growth strategy can be pursued successfully, will depend on the specific situation of the individual enterprise and may be the result of several factors. Before applying a strategy of external growth, the associated potential opportunities and risks must be considered. The following questions may be helpful for this process:

- What are the motives for carrying out an external growth strategy?
- Is there no possibility of achieving growth via internal growth strategies?
- Are the necessary financial resources available in the enterprise for carrying out an external growth strategy?
- Is the specific know-how available for carrying out the due diligence process as well as for the enterprise valuation of potential investment targets to determine an acceptable purchase price?
- How is the purchased enterprise to be integrated in the case of an acquisition?
- What problems can arise during the integration process?
- Are the enterprise cultures compatible and what can be done if this is not the case?

These questions quoted as examples can help to better understand and to structure the process of pursuing a strategy of external growth. They can form the basis on which to develop concrete procedures.

### 7.4.4.3 Co-operative Growth Strategies

**Co-operation** between enterprises involves that *at least two economically and legally independent enterprises work together* with the purpose of reaching a common goal (e.g., increase of market share, improvement of competitive position, risk reduction). In contrast to "going it alone", the cooperating enterprises strive to reach a higher level of success. However, co-operation requires from the enterprises in question that they proceed on the basis of labour division and in accordance with contractual agreements.

The various forms of co-operation can be differentiated according to different **criteria.** Typical examples are the *intensity of the co-operation* (e.g., exchange of information and experience, joint formation of a new business entity), value-chain-related (horizontal, vertical, lateral), *functions* (e.g., procurement, production, distribution), *geographical reach* (e.g., regional, national, international) or *duration* (short-, medium-, long-term). Starting with the variety of forms of co-operation, different co-operative forms of growth of an enterprise can be visualized. These may be *networks, strategic alliances* and *joint ventures.* Like other growth strategies, co-operative growth is associated with specific advantages and disadvantages for young enterprises. Co-operation can have an **advantageous** effect on young enterprises in so far as, for example, an *improved market or resource access,* a *cost reduction,* an *effective utilization of technologies, a better access to capital* or a time-advantage is achieved. Co-operation can, however, also be **disadvantageous** for an enterprise. This is, for example, the case if the *absorption of know-how through one of the partners* only serves his or her own purposes. Co-operation between young enterprises and large, established enterprises can especially lead to *dependencies of the young partner*. The absorption of know-how may include certain product and production technologies and standards as well as organizational structures and concepts in a young enterprise which cannot be secured through industrial protection rights. Also in the area of industrial protection rights, dependencies can be generated because a young enterprise is not in a position to protect its innovations through, for example, patents or registered designs, due to a lack of finance, time or knowledge, or because it has simply been forgotten in the product development process. An established enterprise with its resources and knowledge in this field could simply file an application for a patent or register a design without the young enterprise. Dependencies and lawsuits can also occur in connection with the registration of brand names. To generally avoid lawsuits relating to protection rights, all relevant points should be regulated in advance of the co-operation by contract. Overall, in co-operation projects of young enterprises with large, established enterprises the potential chances and risks of a co-operation must be weighed up against each other and monitored continuously in individual cases.

The established IT network provider *Cisco* frequently enters into co-operation projects with young innovative enterprises. *Cisco* pursues a strategy which may be coined window-on-technology through which *Cisco* continuously aims at new insights and a potential access to the latest innovations within the sector of information and communication technology. This leads to many, diverse advantages for the young co-operating enterprise. Thanks to the high resource capacities of *Cisco*, joint co-operation projects can be targeted and realized. But also co-operative distribution and marketing strategies may be pursued. If an enterprise interests *Cisco* and it adopts the *Cisco* strategy of striving to become number 1 or 2 in each active market segment, it may be suitable as a potential acquisition object. Whether the takeover strategy of *Cisco* is evaluated positively or negatively will depend on the attitude of the young enterprise, its founders and shareholders. It may even be possible that an acquisition by *Cisco* is also a strategy option for the young enterprise itself.

In an ideal case, the co-operating enterprises utilize their mutual strengths for the benefit of all partners involved. Young enterprises in particular can already in early development phases generate advantages for building up own resources and thereby growth through co-operation. Co-operation between young enterprises usually occur mostly between two (or a small number) of partners, with such close co-operation taking place in practical areas of mutual need, e.g., in the areas of research and development or distribution. In addition, it is of crucial importance for the market success of a young enterprise that it has numerous contacts and relationships to players within its environment at its disposal, e.g., to investors, technology partners, suppliers and research facilities. Sometimes this may involve close proximity to research universities and to the professional communities within the industry the new enterprise operates in, for example, the Bio-Design Network at Stanford University, USA which offers young biotechnology start-ups and nascent entrepreneurs access to established enterprises in the industry as well as to important equipment suppliers and bio- and medical technology investors.

#### 7.4.4.3.1 Networks and Network Management

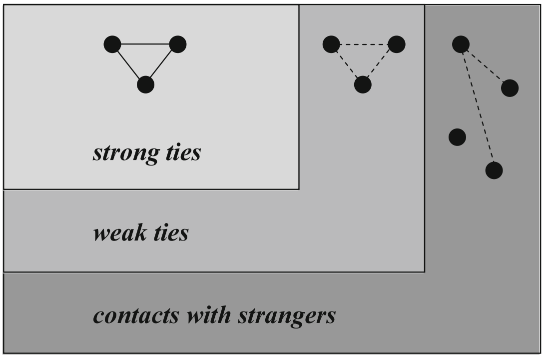
Networks are applied in different disciplines, such as sociology, computer science, electrical engineering and economics. Depending on the perspective taken, the concept of networks is differently defined and adapted to specific requirements. In graph or network theory, a **network** can be defined as *connections*, i.e., the ties, *of a multitude of (autonomous) elements or objects*, the knots. Concrete forms of this type of networks are, e.g., computer networks, telecommunication networks, the National Grid, as well as social networks and economic networks or entrepreneurial networks.

Within the context of co-operative growth strategies of young enterprises, specifically business networks and founders' personal networks are of interest (i.e., social networks between people). Personal networks of entrepreneurs refer to “the set of people to whom they are directly linked” [Aldrich (1999, p. 81)]. In the early phases of enterprise development, the social networks of the founders are prioritized in face of initially lacking external relationships of the enterprise itself [Lechner/Dowling (2003); Hite (2005)]. In addition, social networks of the employees are brought into the build-up of an overall enterprise network, especially in young enterprises. Especially in the networks of smaller and younger enterprises, friendships or close family bonds often serve to cultivate business relationships to other players and institutions via bridging contacts. These relationships can lead to an exchange of information, labour or other types of material and emotional support. In a network of young enterprises, there is often no organizationally legitimized authority of individual players. Such a network can, in principle, be seen as open and changeable.

Within the network, the intensity of the bonds between the individual players will vary as will their importance to their entrepreneur (e.g., depending on the development stage of the venture) [Aldrich (1999); Lechner/Dowling (2003)]. One can, for example, distinguish between *strong ties*, *weak ties* and *contacts with strangers* [Aldrich/Brickman Elam (1997)].

Illustration 7-15 shows basic types of network relationships. [See Aldrich/Brickman Elam (1997)]

***Illustration 7-15:*** *Network relationships*




**Strong ties** can be characterized as strong, close and reliable network connections. They generate *solidarity, predictability* and *trust* as basis of a social influence. The number of strong ties of a person is, however, limited, as these usually demand much time and attention to maintain. Due to a cognitive balance or similar way of thinking, strong ties often lead to the formation of groups of linked people. [This is also the reason why it has been argued that such close ties may be less valuable for entrepreneurs to access new information and important stakeholders. Such close ties tend to have a similar knowledge base and know the same people then the founder does and thus offer only little benefit.; Jenssen/Koenig (2002).] The strong ties of entrepreneurs normally refer to individual business partners, a few friends and family members. Strong network relationships can be advantageous for young enterprises under certain conditions. This applies above all in the wish to build up and cultivate long-term and sustained business relations in an entrepreneurial environment which is characterized by uncertainty. In many cases, close network ties are indispensable for the survival of a young enterprise.

**Weak ties**, on the other side, can be described as loose, weak network connections between various players. Weak tie relationships are characterized by usually a *shorter duration* and *intensity of the network tie* associated with a *greater insecurity, lower reliability* and opportunism. At the same time, these are more expendable compared to closer networks, as they usually do not contribute to group formation because the network members are characterized by low emotional bonding. Entrepreneurs have in practice significantly more weak than strong tie relationships. Weak ties are important in change, innovation and diffusion processes during enterprise development by generating and disseminating new information. Moreover, weak ties may also offer material resource support, e.g., access to capital [Jenssen/Koenig (2002)]. Weak ties form bridges to other players and strong-tie relationships, for example, assisting in indirectly accessing potential customers or technology partners.

The third form of network relationships are the so-called **contacts with strangers.** As here the contacts are mostly new ones, they represent a very detached, uncommitted, pragmatic relationship which is often of a very short duration. An example for such a connection is the purchase of a machine which an entrepreneur acquires on the basis of a newspaper advertisement. The significance and the added value of such contacts with strangers are generally difficult to assess for a young enterprise. In phases of start-up and early enterprise development, strong and weak ties should rank above contacts with strangers for a young enterprise. In the further course of development, when the young enterprise is slightly more stable, the contact with strangers could gain in importance. Generally speaking, no universally valid statement can be made at this point as regards the *general* advantageousness of strong ties, weak ties or contacts with strangers. It has to be decided on the basic of the specific situation as regards the development of networks and development of the young enterprise whether, for instance, strong ties, weak ties or a mixed variant can be called advantageous. For an enterprise founder or entrepreneur, well-balanced strong and weak network relationships are recommended that are characterized by stability or sustainability yet balanced by variety [Aldrich/Brickman Elam (1997)].

The typology of the three forms makes it possible to better understand and classify network relationships. On this basis a young enterprise is, for instance, in a position to establish and to cultivate network ties more consciously, target-related and possibly more effectively.

One **aim of enterprise networks** can be seen in the *optimization or maximization of their usefulness to the network participants,* i.e., to enterprises or founders. The usefulness can refer to the level of individual network members but also to an overall goal for the network. Its aim is the generation of an advantage for the members of the network over others who are not integrated into networks. Thus a young enterprise can, for example, gain a better access to the market. *Enterprise networks* are an *instrument for realizing growth strategies.* Through the active utilization of a network the growth of a young enterprise can be promoted and supported, as networks sometimes take on the function of supplying resources, i.e., they make labour, capital and information or other tangible and intangible resources available which cannot be produced or provided internally within the enterprise.

**Network Build-up and Network Management**

From a dynamic perspective, it seems to be important to build-up a broad network of social relationships which can be brought into the enterprise already in advance of founding an enterprise. In the **pre-founding emergence and start-up phase**, social networks can serve to generate and accumulate ideas as well as to assemble resources. Already at an early stage, networks can generate a considerable advantage for the later growth of a young enterprise. In the **growth phase**, the social network of founders changes into an enterprise network. This can be practically used for realizing and supporting entrepreneurial strategies. In this way, the enterprise network has an essential strategic significance for young enterprises.

Network relationships of enterprises facilitate the access to previously unavailable resources and thus contribute to overcoming their handicap of small size. The network build-up and network employment can form a central component within the growth strategy of a young enterprise. First, the planned combination of internal enterprise resources has to be aligned with a specific enterprise strategy. To be able to realize this strategy successfully, it must be examined whether the required resources are already available in the enterprise. If this is the case, a network can be seen as a supporting function. If not all the necessary resources for a target-oriented growth exist in the enterprise, external resources can be acquired via a network. [See Stevenson/Gumpert (1985) for this strategy of gaining control of and access to external resources, e.g., the know-how of others rather than owning them directly.] In this situation, the individual specific strong ties and weak ties are to be taken into account. Networks can be advantageous for young enterprises for compensating lacking resources through network contacts. For this reason, founders should think about the following questions:

- What network members are present in founders' social networks?
- Which material and non-material (e.g., know-how) resources are available to the individual players in a network and could these resources be of benefit for a new venture project?
- How can new resource providers be reached and bound into the network?
- Are the relationships strong ties or weak ties?
- Through which network members as bridging contacts can external resources be obtained for the enterprise?

- How much time must and can be employed for building-up and cultivating the network?
- How can the network be aligned and used purposefully for the generation of growth?

Many further different questions could be raised which might be important within this context. It is up to the founder to consider questions such as the composition, structure and cultivation of the network to be able to utilize it within a co-operative growth strategy.

### 7.4.4.3.2 Strategic Alliances

A **strategic alliance** is an *agreement of two enterprises about a co-operation or collaboration.* It is also often called *strategic partnership.* In a strategic alliance, the co-operation takes place on a voluntary basis between two or more enterprises which are legally and economically independent. In other words, *no institutionalization of the co-operation relationships* exists within the meaning of the formation of a new, legally independent company. The partners of the strategic alliance discuss, agree and carry out tasks jointly based on the division of labour and pursue common goals. The targets can be related to the whole enterprise or to specific areas, e.g., *research and development, marketing and distribution* or *procurement* (e.g., a collaboration project between a small bio-tech start-up and an established pharmaceuticals company to develop new drugs). The individual function areas are combined with each other to achieve a strengthened competitive position. Moreover, a combination of complementary function areas could be visualized. In this case, the partners utilize their individual strengths (e.g., the above bio-tech start-up may focus on drug development while the pharmaceuticals company will be responsible for later distribution and marketing). In some cases, functions can also be outsourced to the partners. From the formation of a strategic alliance young enterprises typically expect a strengthening of their resource base as well as an improvement of their market and competitive position. At the same time, the core competencies of the individual partners can lead to a new market-related combination of resources. There are numerous practical examples of young as well as established enterprises for strategic alliances which are targeted at *fulfilling a joint objective.* The co-operation can cover almost the complete value creation chain. A well-known example is the alliances of airlines. The "Star Alliance", for instance, has made the transport of passengers the subject of their joint task. In this case of a strategic alliance over- and under-capacities of flights are better distributed which leads to an optimization of the employment or structure of resources. Also, strategic alliances in the automobile industry can be noted, e.g., in research and development work and the transfer of results. Another example is the strategic alliance between the *MAN Nutzfahrzeuge AG* (commercial vehicles) and the *Navistar International Corporation* (diesel engines, bus chassis, spare parts) which comprises a co-operation in research and development and procurement, as well as in the production of components and systems for commercial vehicles. The primary aim of this co-operation is to generate synergy effects by sharing development costs as well as a joint production and purchase volume.

In the area of the information and communication technology business, there were and are many examples of strategic alliances. A significant alliance was the "PowerPC" alliance between *Apple*, *IBM* and *Motorola* for the development of a new RISC processor called the PowerPC (based on IBM's POWER architecture), an alliance started in the 1990s to rival Intel's PC market dominance. Similarly, *Toshiba* also owes its position on the world market to the fact of the possession of core technologies for the development and production of PCs. It had formed several strategic alliances with other innovators like *Intel* or *Microsoft* to ensure that cutting-edge technologies could be integrated in *Toshiba's* PC's at the earliest possibility. Moreover, *SAP* and *IBM* maintain several strategic alliances in the fields of service, technology, sales and distribution. Both companies provide an integrated IT package of *SAP's* business software and *IBM's* hardware server technology (e.g., the *IBM* "BladeCenter", *IBM* "Power Systems") to Small- and Medium-sized Enterprises (SMEs).

Strategic alliances are also regularly formed in the area of biotechnology. Often these are global strategic alliances. An example is the strategic alliance between *Applikon Biotechnology* (Netherlands) and *GEA Diessel* (Germany) for the delivery of turn-key facilities (bio-reactor-systems) in the micro-litre area up to complete production systems. The strategic alliance ranges from construction, production, installation to sales and marketing and combines the core and complementary knowledge of both companies.

Within the context of strategic alliances, the trust of the partners involved is of special significance, as a strategic alliance can lead to dependencies of one partner on the other partners. *Information asymmetries* can then lead to the exploitation of the resources of one partner and, in an extreme case, to the breakdown of the enterprise. As with many co-operation forms, the chances and risks of a strategic alliance have to be weighed carefully against each other alongside the following core issues:

- What may be possible partners for strategic alliances and what are the objectives of teaming up with others?
- What dependencies can occur within the framework of a strategic alliance?
- How may these potential dependencies be avoided?
- Which opportunities and risks are contained in a potential strategic alliance?

#### 7.4.4.3.3 Joint Ventures

**Joint ventures** generally refer to a *co-operation of at least two enterprises* in which the *formation of a new, legally independent company* is carried out to realize co-operative aims. Within this meaning, the chances and risks of success are distributed in a joint venture over two or more enterprises. All the co-operation partners participate *financially and legally* in the new enterprise. The *capital investments* can be distributed *at par* over the number of partners, but this does not always need to be the case. In addition, different quota of capital shares may be linked to specific rights and obligations as well as advantages and disadvantages, which are derived from the legal form as well as the laws specific to the country concerned. In the distribution of the capital shares, enterprises often make sure that no share holder takes a domineering position. However, it can also be advantageous to choose an *asymmetrical capital distribution* in order to transfer leadership of the joint venture to one enterprise. This is, for instance, the case when operative leadership processes are to be regulated and voting processes should be minimized which might lead to a delayed decision making and implementation. It is thus intended to make the enterprise more *agile.* Detailed attention must be given to formulating **control rights and protection rules** which are ultimately intended to contribute to the protection of the minority corporate members.

To carry out a joint venture, **financial and material resources are brought in** as well as **non-material resources**, in particular the *know-how* of the individual partners involved. Possible resources to be brought into a joint venture are *capital, personnel, buildings, machinery and plants, patents, licences* and other *protection rights, contacts to customers and suppliers* as well as *specific know-how,* e.g., in the area of *marketing.* The contribution of resources which go beyond pure capital investments is particularly important. This is because through a joint venture a new specific combination of resources is generated which may lead to *competitive advantages.* Young enterprises sometimes need complementary resources for the realization of an idea, a product or a project which can be made possible through a joint venture. A partner can also bring into the new enterprise a certain *reputation*, which may lead to a greater credit-worthiness or a higher level of customer acceptance and faster market growth. Moreover, *market entry barriers* can be overcome by forming a joint venture. This procedure is often required when entering international markets (e.g., China). By forming a joint venture with an enterprise of the targeted country, legal as well as cultural market entry barriers can, for instance, be overcome. Since the end of 2005, for example, suppliers for Chinese invitations to tender must prove a local value creation of at least 70 percent. To overcome this market entry barrier, the wind turbine manufacturer *Nordex* has founded a joint venture with the regional Chinese energy supplier *Ningxia Electric Power Group* and the power station and construction company *Ningxia Tianing Electric Energy Development Group.* The joint venture comprises the production of megawatt wind energy installations in China. In the Chinese province of Ningxia, the *Nordex Wind Power Equipment Manufacturing Co. Ltd.* will in future produce wind turbines in the output class of 1.5 megawatt.

In spite of extensive formal regulations, the basis of trust also constitutes an important component in a joint venture. Compared with other types of co-operation, a joint venture is a relatively close association between the partners involved, which leads to an intensive form of co-operation. A possible inflexibility as a disadvantage of the joint venture contrasts with the advantage of risk diversification between the joint venture partners. In practice, there are numerous examples of **joint venture** co-operations of young and established enterprises. The North-American joint venture *MG Biotherapeutics LLC*, for example, was founded between the medical technology company *Medtronic Inc.* and the bio-technology enterprise *Genzyme Corporation.* The aim of the joint venture is the development of new forms of treatment for serious types of heart diseases. Another example of an international joint venture is the co-operation between *Q-Cells AG* (Germany) and *LDK Solar Co. Ltd.* (China) which agreed in April 2009 on a joint venture to build large photo-voltaic machines. The target of the joint venture is to increase market development in Europe and China, as well as to achieve cost reductions by optimizing the value chains of the two enterprises.

Advantages and disadvantages as well as chances and risks of a joint venture must finally be weighed against each other in the individual case. For this purpose, the following questions could be used:

- Which aims are pursued with a joint venture?
- Who are the participating partners?
- Are there any dependencies between the individual partners and how severe will they be?
- Who contributes to achieving the overall aims of the joint venture and how much?
- How should the ownership and capital structure in the joint venture be formed?
- Who obtains which control, instruction and direction rights and what is their concrete form?
- What resources are brought in to the joint venture and by whom?
- How are the work results in the joint venture utilized?

### 7.4.4.3.4 Franchising and Licensing

The importance of the concepts of *franchising* and *licensing* has significantly increased over the last few years, also with regard to their international and to some extent even global dimension. Against this background, the two concepts will be discussed in the following.

**Franchising**
Franchising has its origin in the USA and refers to a rapid growth which started in the 1960s and has continued into the present. Up to the present, franchise systems such as *McDonald's* or *Pizza Hut* have become known all over the world and can be quoted as successful examples for the realization of global growth strategies through franchising. Today, franchising constitutes an important section of economic value creation in the

USA as well as in other Western economies. For example, around 40% of all retail sales in the US are generated by franchise businesses. [Dormann/Ehrmann (2007)] What is to be understood under franchising in relation to new enterprise formation and growth?

**Franchising** can be defined as a distribution system organized as vertical co-operation between legally independent enterprises. In the USA, franchising emerges as an instrument of sales organization. For example, as early as 1860 the Singer Sewing Machine Company organized distribution via independent dealerships and General Motors first established franchising in the form of co-operative distribution [Rupp (2006)]. In general, "the franchisor sells to the franchisee the right to do business under a name, the right to a product, a process, or service; training and assistance in setting up the business, as well as ongoing marketing and quality control support once the business is established" [Allen (2003), p. 404]. Typically, a legal continuing obligation exists, as the franchise contract between franchisor and franchisee is designed for a long-term co-operation. Although a close co-operation exists between the franchisor and franchisee the enterprises involved remain legally independent. Franchising thus represents a special form of new enterprise formation. The aim is to achieve sales promotion on the basis of a partnership-distribution system under a uniform market appearance. With franchising, products, services or technologies can in principle be distributed. The classical distribution franchising (dealerships) is today complemented by further forms, such as, for instance, product and service franchising [Skaupy (1995); Allen (2003)].

Franchising operates according to the principle of "once designed and x-times sold" [Müller (2005)]. The franchisor provides his franchisees with an already market-tested business concept against payment of a remuneration. At the same time, the franchisee enters specific obligations for the realization of the concept, such as, for example, the marketing concept. The franchisor offers to the franchisee *technical* and *managerial* support and ensures the planning, implementation and control of the business system. The services of the franchisor can also include measures for training and further training as well as further developments of the franchise system. However, the individual contributions of the franchisor also vary according to the franchise concept in question and his market position. To ensure system-conforming behaviour, the franchisee is subject to a concept-specific instruction and control system.

The contributions, rights and obligations are laid down in the form of a franchise handbook and made available to the franchisee. The **franchise handbook** represents the *written description of the franchise system.* This includes amongst other things the *definition of the system,* its *corporate identity,* the *presentation of the operating methods* as well as the *training documents.* In addition, the *operating* instructions as comprehensive (technical) directions for carrying out the organization as well as the business operation and the management of the employees are contained in the franchise handbook. *Explanations and instructions* for the areas of *marketing, administration* and *finance* are also included. The franchise handbook thus comprises all relevant data, information and contacts for the planning, implementation and realization of the franchise concept.

Both contract partners, the franchisor as well as the franchisee, must take on different rights and obligations. The **primary services of the franchisor** consist in the following points:

- Definition and development of a procurement, distribution and organization concept
- Provision of the privileges to use protection and proprietary rights (patents, licences, brand names)
- Training of the franchisee
- Obligation to support the franchisee actively and continuously with regard to business administration and technology
- Continued further development of the business idea

The following aspects can be listed as **primary services of the franchisee:**

- Entrepreneurial activity in one's own name and on one's own account
- Obligation to use the franchise package and to pay a franchise fee
- Provision and employment of labour, capital and information

Some people doubt that the franchisee carries out an entrepreneurial activity as he utilizes the business concept and the multiple services of the franchisor. As the franchisee manages, however, a legally independent enterprise and acts in his or her own name and on his own account by employing labour and capital, the activity qualifies as entrepreneurial. This means that franchisees carry an entrepreneurial risk and that, as in other enterprises, failure cannot be excluded [Spinelli/Rosenberg/Birley (2004)]. It is true that the franchisor provides assistance and the transfer of know-how which can support, facilitate and accompany the entrepreneurial activity. This does, however, not guarantee, generally speaking, certain entrepreneurial success. However, it is possible that the entrepreneurial risks are reduced by franchising. On the other side, the uniform market appearance and the central contractual obligations of the franchisee also restrict their entrepreneurial creative scope and freedom. The fixed and variable (turnover-based) payments which have to be made to the franchisor, can also negatively affect the aspired development of the franchisee. Table 7-6 shows essential elements of a franchise contract.

*Table 7-6: Contents of a franchise contract*

| Criteria | Discussion |
|---|---|
| Preamble | – Basic principles, development<br>– National and international business figures |
| Subject of the franchise contract | – Leadership and product/service range<br>– Rights of use and industrial protection rights |
| Contract territory | – Territory and customer protection |
| Rights and obligations of franchisor | – Detailed representation of know-how<br>– Initial training and further training<br>– Marketing, controlling and further development of the concept |
| Rights and obligations of franchisee | – Representation of the creative freedom of the franchisee<br>– Types and conditions of procurement obligations<br>– Payment of franchise fee<br>– Provision of labour, capital and information |
| Contract duration, cancellation | – Mostly 5-10 years (reason: start financing)<br>– Cancellation rules (franchisor and franchisee) |
| Revocation right | – Right of withdrawal and contractual consequences of revocation |

From the point of view of the franchisee, the business model as offered by the franchisor as well as the contract components should be examined critically and also compared with possible alternatives. In particular, franchising can offer the possibility to participate in the rapid growth of a business concept and its nation-wide (or even international) market presence; as such franchising constitutes an important option for realizing a growth strategy [Allen (2003)]. As with other co-operative forms of growth the advantages and disadvantages must be carefully weighed against each other. A model covering a broad range of relevant factors influencing the decision-making process of a franchisee to purchase a franchise license or not is discussed in Kaufmann (1998, p. 348). Kaufmann combines the decision to become self-employed in the first place and the selection of a specific franchise format in terms of choosing an adequate organizational format and business sector.

The following questions may be of use for business founders considering to start a franchise business:

- Is the franchisee in a position to meet the sometimes restrictive requirements of the franchisor?

- How comprehensive or restrictive are the franchise concept, the franchise handbook and the contract?
- How detailed and credibly does the franchisor present the growth prospects of the franchise concept?
- Can the system be imitated in an independent form?
- What is the unique selling proposition and competitive advantage of the franchise concept?
- Has the franchise concept already been tested on the market and, if yes, to what extent?
- How successful are individual franchisees?

For further information about franchising please refer to the European Franchise Federation [www.eff-franchise.com].

**Licensing**
The concept of licensing is closely connected with that of franchising. "Like franchising, licensing is a way to grow a company without investing large amounts of capital in plant, equipment, and employees" [Allen (2003), p. 407]. These concepts are not always clearly distinguished, however. In principle, the *degree of independence of the entrepreneurial activity* can be used as indicator to distinguish between the two concepts. In **licensing**, *the licenser gives the licencee a licence, e.g., for the manufacture or distribution of a product or a service* [Allen (2003)]. The entrepreneurial use of a licence is usually controlled less strictly than in franchising. There are, however, overlapping areas of both concepts, depending on the layout of the contract. For young enterprises in particular, many and diverse possibilities offer themselves within the context of licensing, be it as licenser or as licencee.

One possibility of promoting growth purposefully without binding internal resources too strongly or building up new resources is the licensing of technologies in return for receiving royalties. The business model of *Google,* for example, shows two (main) subordinate areas, the search service and *Google*'s advertising service range. Within the search service, *Google* offers the possibility of licensing its search technology to other enterprises, which can employ it within the framework of their own internet offers or internet search portals. A well-known licencee of the *Google* search technology was *Yahoo!* from approximately the middle of 2000 to the beginning of 2004. In 2004, *Yahoo*! decided in favour of a further development, utilization and distribution of its own *Yahoo*! search technology. Other well-known licencees within the context of internet portals are *AOL* and *T-Online.* In addition, licensing within the framework of the *Google* "Search Appliance", a combination of hardware and software, is available for the search in the intranet of enterprises. The *Google* Search Appliance reproduces the well-known *Google* search in the intranet of the licencee's organization. Well-known clients are, for instance, *Xerox,* the *World Bank Group, Cisco* and *Procter & Gamble.* Smaller enterprises are offered *Google* mini. The *Warwick Business School, Texas A&M Foundation, De Anza College, University of Oklahoma* and the *Dominican University of California* are among their customers.

Other examples for licensing as a part area of a business model are the manufacturers of computer games, such as *Epic Games* or *id Software*, who produce and distribute games on the basis of their own 3D-game development and game presentation environments, the so-called engines or game engines. In addition, these enterprises offer the possibility of licensing these technologies to other enterprises, with the licencees then using this core technology for developing their own games. For *id Software*, the application extends also to other areas, such as, for example, the 3D-visualization in web-browsers for the generation of virtual museums or for the real time presentation of architectures (architectural visualization). Licensing strategies offer a potentially successful business model and contribute to the growth of new enterprises. In *Epic Games* or *id Software*, the number of games developed externally by licencees is several times higher than the original games developed by both enterprises. Based on the "Unreal Engine" provided by *Epic Games*, for example, over 50 titles with a total number of over 16 million copies have been sold so far. Well known titles or series like BioShock, Medal of Honor, Borderlands or Batman: Arkham Asylum are powered by the Unreal Engine. *Epic Games* has a workforce of 100 people and its own Unreal series of games have sold over 7 million copies worldwide on six platforms. [www.epicgames.com; www.unrealtechnology.com]

Licensing offers various advantages for the licenser. The technology is, for instance, spread and the enterprise achieves a track record through licences, a history of technology successfully employed by the customers. These testimonial customers can be employed advantageously within marketing to acquire new customers [for reputation building through customers see Reuber/Fisher (2005)]. The presentation of the trust, which satisfied customers put into the technology, is an essential point when looking for new customers.

Licensing can be carried out in two ways. As in the example of *Google*, direct licensing can be offered. In this case, all resources lie within the enterprise and the licencee can be chosen and supervised directly. On the other hand, a marketing or distribution co-operation with other enterprises is conceivable. For young enterprises it can be advantageous not to carry out the marketing of the licences for their technology themselves, but through a co-operation partner, especially if the marketing of the technology requires a substantial amount of advisory support, and the required personnel resources are not available and would have to be hired in addition. For example, marketing licences may be based on a success fee.

Overall, it is important to avoid depending on a few licencees or even a contractual exclusivity, especially if the technology is new making it difficult to correctly assess the (market) potential. The following questions can help to structure and evaluate licensing:

- Are the technologies to be licensed protected by industrial protection rights?
- Which partners are suitable to contribute to the growth of the enterprise through licensing?
- How strong is the mutual dependence of the contract partners in a licensing agreement?
- Is there a risk for the licenser of losing know-how or technology to the licencee?
- Which strategy for market development will be best and how many licences should be granted to external?

### 7.4.5 Growth within the Context of Collaborative Technologies

Many and diverse forms of co-operation have appeared in the course of the last few years, especially in the area of information and communication technology, with collaborative technologies increasing continuously. For young enterprises in particular, collaborative technologies offer many entrepreneurial opportunities. [For this topic see Volkmann/Tokarski (2006a).]

The internet has facilitated the world-wide network-integration of individual market actors and users irrespective of whether they are individuals, enterprises or other organizations. Networking offers various possibilities for realizing growth strategies, including the possible use of numerous collaborative technologies for realizing these strategies. Within this context, collaborative technologies are to be understood as technologies which facilitate a communication and an exchange of information between e.g., individuals and enterprises [for technology concepts see, for instance, Badach/Rieger/Schmauch (2003)].

Often, young enterprises have only little experience in new strategic business fields of information technology. Start-up formation and enterprise growth are therefore associated with increased technological risks. A reduction or spread of risk in the realization of technology-oriented growth strategies can be achieved through employing collaborative growth strategies. Typical for young enterprises in this context are:

- Product co-operation
- Communication co-operation
- Distribution co-operation
- Innovation co-operation

In this context one can often hear the (buzz) word **Web 2.0**. It was introduced in public at the O'Reilly Media Web 2.0 conference in 2004. The term Web 2.0 can be perceived as the second customer centric and interactive generation of web development and design. In essence it consists of user and/or machine communication, as well as secure information sharing and collaboration on the internet respectively the Web. Thus, Web 2.0 comprises the idea of the growth of interactivity and interconnectivity of web-delivered content.

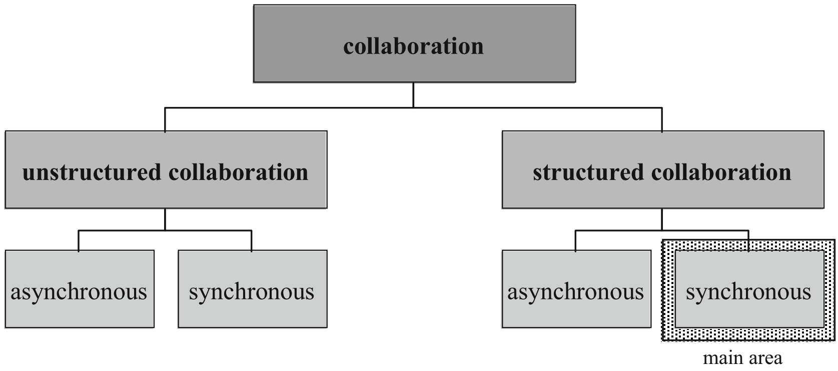
Most modern *social-networking sites* (www.xing.com; www.linkedin.com; www.twitter.com; www.facebook.com; www.myspace.com) *video-sharing sites* (www.youtube.com; video.yahoo.com; www.clipfish.de), *wikis* (www.wikipedia.org), *weblogs a.k.a. blogs* (www.blogger.com; wordpress.com) are Web 2.0 applications. The term Web 2.0 does not implicate whole new technologies for the development and the design of web based services, applications and internet sites. In fact, it is more of a user-centric approach of using the internet and developing new business models. Surely technology has evolved over the last years, and to run a Web 2.0 site, several technologies like JavaScript, XML (Extensible Markup Language), AJAX (Asynchronous JavaScript and XML), Web APIs and core internet technologies (such as network protocols) have to be used. But they are not completely new, rather, it is the approach of leveraging them that is new. Within the Web 2.0 approach technologies are used to fulfil the idea of a customer centric business model of interactivity and interconnectivity making collaboration between humans and/or machines an essential aspect.

**Collaboration, Web Services and Growth Strategies**

The concept of **collaboration** can generally be understood as *working together with the support of new (internet) technologies and technical aids* within the meaning of an organized information exchange [Nenninger/Lawrenz (2001)]. As collaboration is an *organized* information exchange, it is also associated with the co-operation of different market actors. Thus, *collaboration also includes co-operation.* This means on the one hand, that *technological competencies* or technological knowledge are relevant. On the other hand, the *identification, modelling, simulation, management, supervision* and the *integration of (business) processes and systems* are significant [Silberberger (2003)].

Illustration 7-16 provides and overview of different dimensions or forms of collaboration.

*Illustration 7-16:* *Forms of collaboration*




**Unstructured collaboration** *does not follow a clearly defined schedule.* It can occur ad hoc, as this form of co-operation does not comprise fixed structures and processes. **Structured collaboration**, in contrast, can be defined as the *creation and standardization of inter-organizational information, data and process standards.* In addition, a further subdivision is possible into (time-related) *synchronous or asynchronous collaboration*.

*Synchronous structured collaboration* is gaining increasing importance in practice. Web services are, for instance, to be seen as a form of synchronous collaboration. Generally, **web services** facilitate the *interlinking of distributed applications through the internet on the basis of technologies like XML and HTTP.* Web services allow for the calling up a remote method or function in a third party system and enabling communication and data exchange between different systems as Application Programming Interfaces (API).

From *the point of view of business management, web services* can also be defined as *(business) processes carried out via the internet and therefore across enterprises* [Silberger (2003)]. Communication, product offers and distribution represent potential areas for co-operation which can be supported by targeted collaboration. By using collaborative technologies, different growth strategies can be realized.

Within the area of **communication,** *viral-marketing, marketing programmes* and *affiliate programmes* play a role [Kollmann/Herr (2003)]. Within these dimensions, primarily *unstructured collaboration* is used. In **viral marketing** [Kollmann (2001)], *asynchronous* collaboration tools are employed (e-mail, SMS communication, discussion forums, links) that transfer information in the form of an individual or mass communication from enterprises to third parties and use these as a multiplier to spread information rapidly. In this exchange, the information is *pre-structured* and made available to partners. The situation is similar with **marketing programmes,** where information is exchanged through and with the aid of B2B communities. There, the partners function as moderators. With **affiliate programmes**, *banners* or *product* or *text-links* are set with the partners, which lead to the product of the enterprise and are designed to encourage the purchase of products. In this case, the partner participates in future *transaction profits.* The co-operation aspect of distribution is again included on the one side, and on the other side there is the possibility of integrating search masks, e.g., via (static text) links. This approach can already be assigned to the area of structured collaboration.

*Structured collaboration* is made available via web services. Well-known leading examples of growing enterprises which increasingly use this technology include *Amazon, eBay* and *Google*. *Google* makes it possible for private websites to utilize the search technology of the web service on their *own* site and thereby start searches from their internet site. In addition, it is possible to integrate the *Google*-search bar into software applications to permit a request from the *Google* search engine. *Amazon***,** on the other hand, offers the possibility of *integrating parts of the Amazon shop, e.g., catalogues, seamlessly into own websites* in order to network, for example, the current content of books and to generate additional sales. A linking to existing affiliate programmes is possible. The *Amazon* Web Service APIs allow, for instance, *to set up one's own bookshop with complex search functions and context-related search results.* In this way, an individual bookshop can be generated from the database of *Amazon*. This shop is then not operated directly by *Amazon*, but by third parties of the *Amazon's* partner programme. The partner participates in the turnover of the bookshop with a defined percentage (e.g., 15 percent).

So far, these web services are, however, used unilaterally as a *mono-directional form of* communication. Using the structured collaboration of web services (as services), data are transferred from the systems or databases of *Amazon* or *Google* and integrated and represented within one's own website [Hauser/Löwer (2004)]. Moreover, a *more complex integration* of different software systems within web services as middleware or furthermore a service oriented architecture (SOA) would be conceivable in the near future.

The integration via web services can be almost seamless. Taking into account some restrictions, the information and data can be adapted to the layout of the website and become thus a *sub-area* of the (third) website. This relationship can be designated as a *"web-service-communication"*. It belongs to type: "1 to n communication", but fulfils the other conditions of *market place communication* (direct, interactive, push/pull). This form of structured collaboration does not represent a pure search query which meets the "pull-criterion". Rather, the web services offer the possibility to *realize an interactive "push/pull communication", as an* integrated *communication takes place.* Through the previously discussed first form of utilizing published web services, *Amazon*, *eBay* and *Google* offer partners, developers or users the possibility to develop *independent programmes* on the basis of these available technologies.

Structured collaborations are positively encouraged or facilitated by the **strategy of technology leadership,** i.e., *continuous innovation,* of these (young) enterprises. And this technology leadership has to be protected continuously by own research & development (R&D) as well as joint ventures, strategic alliances and mergers and acquisitions [see also chapter 7.4.4.2.1, 7.4.4.3.2 and 7.4.4.3.3]. For example, *Google* is currently the central starting point in the search for information from the web. The company possesses the strongest network infrastructure for caching, analysing and exploiting information and websites as well as e-mails and other data (sources) like images or videos. So the *Google* technology platform (their strong hardware and software architecture and know-how) can be seen as the basis of their business because (nearly) every new idea or (internet) business model developed by Google can be run on their highly scalable systems (like, e.g., Buzz, Gmail, Google docs, Google maps, Google reader, Google sites, Picasa or YouTube).

As regards *Amazon*, the fact that it has made its database available (to third parties) so that resellers can integrate their shops or offers into the "*Amazon flow*", is seen as a positive strategy. The strong technological competence of *Amazon* forms the internal basis for the realization of the firm's business model. Second, this competence is used for providing technologies for the extension of the business model on the basis of external collaboration.

The importance of the employment and the benefit of structured collaboration can be illustrated by a quote of the co-founder of *Google*, Sergey Brin:

> *"The best way is to let other people [innovate] for us. With Google APIs anyone can build an application using Google search or spell correction. Instead of hundreds of engineers [working at Google], there are millions that can develop new services using Google infrastructure." [Moore (2002)]*

The **provision of web services** can thus form the *basis for collaborative growth strategies* in the form of *product, communication, distributive and innovation co-operation,* as the further development or external communication of the product is not necessarily any longer carried out *within* the enterprise, but rather in an extremely innovative way with "n-players" with whom personal contact is not required. Web services do not necessarily generate directly new sources of revenue for young enterprises. Rather, they support and strengthen business models, as they facilitate the access to existing services and make it easier to enter into partnerships. The provision of web services integrates a young enterprise into new business processes of different value chains [Moore (2002)]. In the next few years, the characteristics of co-operation and communication between clients, suppliers and selling enterprises will continue to change.

The **organization of knowledge** can take on a new dimension. By means of deep reaching networking using collaborative technologies, a *blurring of the so far clear distinctions in the value chain relationship between suppliers and potential buyers* is conceivable. This may lead to opportunities or growth strategies for new business models. Some business models are to some extent based on this already existing development, such as *eBay*. The principle of players with equal rights is already practiced in *eBay*, as *any person* can take on *various roles* from *retailer to consumer* if required [Gerick (2004)]. It is exactly this peer-to-peer approach, which should be pursued further within the context of growth strategies. First signs such as those from *Amazon*, *eBay* or *Google* with their provision of web service APIs point in this direction.

Programs already exist that, based on the published web services, provide an easy integration of goods into the *Amazon* catalogue. Other programs allow retailers to call up prices via mobile-access devices. The development of applications is, however, not carried out by the web-service provider (*Amazon*), but by a large number of independent developers. These form in some cases own communities, which answer questions and problems independently without the help of *Amazon* personnel. Web services will play an important role in the future of the internet economy. *Amazon* and *eBay* are good examples for a paradigm change. The development of programs is seen as *viral* distribution in analogy to the Linux-open-source-movement. A large community of developers is therefore working on the success of *Amazon without* being directly paid for it.

Summarizing, the **employment of web services** generates a *strong branding of the individual products of young enterprises* (*Amazon*, *eBay* and *Google*) due to a wide reach and global, internet-based market presence. Internet users come into strong contact with the brand names, as these are integrated through the web services and the associated functions into a large number of (private) third party sites and are therefore transported over the entire world-wide web. These activities achieve positive effects within product, communication, distribution and innovation co-operation projects. These developments in the area of the web services are also evident in the fact that the largest world-wide and most influential software producer *Microsoft* is supporting this trend with own developments and partnerships. In addition to this, the interlinking of online- and offline-programs advances. Through the provision of new technologies by *Microsoft*, new web services are to be generated on the basis of the *eBay* web services. It will be possible to generate services with the *Microsoft* Office Suite which make an automatic pricing of offers and an automatic bidding possible. Moreover, via XML *MS's* Excel offers the possibility of integrating listing presentations, graphics, charts and bulk goods. The software allows *eBay* buyers and sellers a dedicated development, controlling and evaluation of business statistics. These new technologies facilitate *custom-made* applications for a direct communication and interaction with the servers and databases of the enterprise which provides the web service. These applications simplify the communication, as interaction does not take place via the graphical user interface of the platform or market place, but the required functions are called up directly as, for instance, with *eBay*: setting-up of offers, calling up category information and offers, analysing articles, processing buyer information at the end of the auction etc.

The development in the area of structured collaboration has, however, only just begun. More in-depth structured integrations of web services as middleware or SOA, e.g., in established "classical" suppliers, manufacturers and distribution relations are conceivable in the future and are pushed ahead by software solutions such as those offered by *SAP*. These developments represent, however, another aspect of structured collaboration and growth strategies.

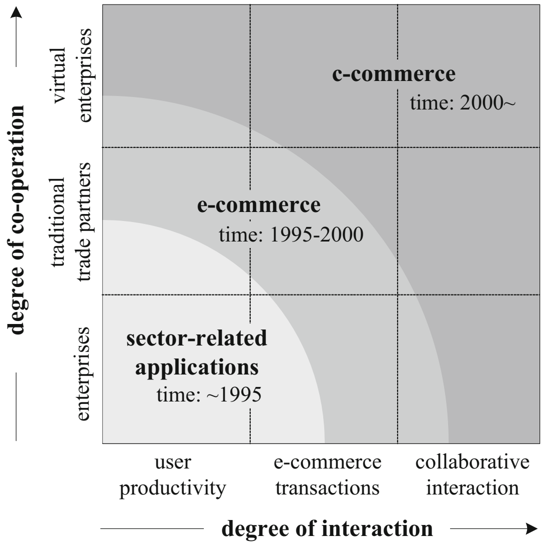
**Perspectives of Collaborative Growth Strategies**

Within the framework of collaborative growth strategies of young enterprises, a **transition is to be made from e-commerce to c-commerce.** Generally, e-commerce is understood as the electronic processing of transactions using public or private networks [Hermanns/Sauter (2001)]. In many definitions, **e-commerce** is a *commerce-related* concept which is limited to procurement and sales transactions. Later definitions extend the described, exclusively commerce-related perspective to the *integration of value creation processes* which can be generated within the enterprise or externally [Wamser (2000)]. With the extension of the concept of e-commerce, it is aimed to no longer restrict new internet technologies to the perspective of transactions [Hermanns/Sauter (2001)].

As an extension of e-commerce, the notion of **c-commerce** entails the **networking** *of the different participants in a value chain via the internet.* The purpose of networking is an *interactive, cooperative working in all areas of the enterprise value chain* [Hayward (2001)]. The c-commerce approach represents thus a higher level of complexity as compared with e-commerce.

The evolution of the c-commerce model shown in Illustration 7-17 comprises the dimensions of the degree of co-operation and the degree of interaction. The d*egree of co-operation* refers to the degree of spatial extension. This can range from within the enterprise to a virtual, all-embracing enterprise organization. The *degree of interaction* comprises the three development levels transactions on demand, electronic trade and joint interaction [Bond et al. (1999); Halpern (2001)].

*Illustration 7-17: Development of c-commerce*




The evolution happens in three phases: integration, co-operation, collaboration [Vering et al. (2001)]. The first phase describes the automation of transactions between partners. The second phase, the access to shared database is possible. In the third phase, the interactive co-operation is described [Yockelson/Sholler/Cain (2000)].

Young enterprises can utilize the knowledge concerning the possibilities of structured collaboration for their **growth strategies.** (Technology-oriented) growth strategies can be realized, which *speed up the transition from the previous transaction approach of the e-commerce world to the collaboration approach within c-commerce. Amazon*, *eBay* and *Google* are examples for the successful conception and realization of growth strategies through a *high degree of interaction* as well as an *intensive virtual co-operation.*

Collaborative strategies facilitate product, communication, distribution and innovation co-operation with a large number of partners in the internet. In this way, the build-up of a brand name can, for instance, be facilitated, and service, development and distribution costs can be reduced. The assessment of the relevance and the usefulness of collaborative technologies for a young enterprise can be supported by the following questions:

- What are the current trends in information and communication technology?
- Which technologies offer potential growth opportunities?

- How can a structured information exchange be made profitable for young enterprises?
- What (technological) know-how must be present within the enterprise?
- How can external (technological) know-how be opened up through collaborative technologies?

# 7.5 Growth Obstacles

## 7.5.1 Problem Areas of Young, Growing Enterprises

Research results point in the direction that higher survival rates of enterprises can be generated through growth [Aldrich/Auster (1986)]. At the same time, the subject of growth is generally given special importance within the context of young enterprises, in particular in the USA, but also increasingly within Europe. Founders usually have to decide fundamentally whether they want to *grow* or *not to grow* with their young enterprise, because not all founders strive for growth, and not all start-up enterprises reach the growth phase [Davidsson (1991)]. The only constant quantity of growth is change. Growth at any price can have a *negative* effect if the management falls into *actionism* instead of *pursuing and following a strategy persistently.* Financially, an ill-constructed growth path of a new business may well generate substantial turnover but never reach profitability.

There are many practical cases in which a founder is content to work on his/her own and to look after a certain number of customers without aiming for growth. In the case of a consultancy, for example, the turnover growth is limited by the available time which the founder can invest in the consultation of clients.

For those founders who decide to grow with their enterprise it is necessary to be prepared for growth and to understand the consequences of growth [Hisrich/Peters (2002)]. Within this context it is not only necessary for achieving successful growth that the founders recognize the entrepreneurial opportunity of growth and would like to grow into the new market segments, they must also have the necessary *abilities and competencies for the management of growth.* It can prove to be fatal for enterprise founders if growth occurs uncontrolled. They must lead and control the growth of the enterprise. Conversely, growth must not dominate the enterprise or the entrepreneurs, e.g., in terms of available management and time resources.

Presented below **are ten warning signs that a business may grow too fast** [Barringer/Ireland (2009)]:

- Borrowing money to pay for routine operating expenses
- Extremely tight profit margins
- Over-stretched staff
- Declining product quality
- E-mail starts going unanswered
- Customer complaints are up
- Employees dread coming to work
- Productivity is falling
- Operating in a "crisis" mode becomes the norm rather than the exception
- The business's accountants are starting to worry

The problems or challenges of growth are determined mainly by the quality and availability of resources as well as the market and customer demand. Often, the founders are more or less *forced* by customers *to pursue growth.* This is, for instance, the case if unexpected high order volumes occur or additional services are in demand. Irrespective of whether the growth of a young enterprise is consciously initiated or involuntarily generated, the challenges which face the management and their enterprise are numerous. They range from problems of uncontrolled growth via lacking organizational structures to bottlenecks in financial or personnel resources. Fundamental "**growth mistakes"** can in an extreme case even lead to the *failure of the young enterprise.*

Typical **growth mistakes and obstacles** can be mainly traced back to *enterprise-internal problem areas,* but in individual cases, also to external factors. In practice there are often several different factors which can have a negative effect on growth simultaneously or successively.

**Competence, Strategy, Structure:**
**Divergences of Growth Strategies and Internal Structures**

While in the founder years much functions still *informally* on call in the team, a *planned and structured approach* becomes necessary in the **growth phase.** Lacking or insufficient growth strategies hamper the necessary structural change of young enterprises. Founders who have given no thought to the relationships between growth strategies, processes and structures and do not know how growth can be planned, directed and controlled, run the risk of getting into difficulties with their young enterprise.

Even if enterprise founders choose a certain goal-oriented growth strategy, they can face specific challenges and problems. This applies, for instance, to an external growth strategy through **acquisition.** Due to the potentially diverging **enterprise cultures** of the acquired enterprises, *problems of adaptation and growth obstacles* may occur, as young enterprises have usually already developed their own independent enterprise culture. It manifests itself in organization-wide *value systems* adopted towards customers, suppliers, investors and other stakeholders. The clashing of different enterprise cultures in acquisitions demands an adaptation and harmonization of the enterprise cultures so that the aspired acquisition advantages, e.g., in the form of synergy effects, can be achieved. Enterprises from the technology sector, such as *Amazon* or *Cisco*, have shown in the past that an external growth strategy through acquisition can definitely succeed in overcoming the problems of growth from new ventures up to growth enterprises. These enterprises have concentrated on acquisitions which constituted an extension or **complementation** of their individual **core competencies.** An increased level of *risk* in a growth strategy through the acquisition of enterprises lies, however, in the *diversification* into other, unfamiliar business lines. This is especially the case if the knowledge and expertise of the business line in question is only insufficient or even lacking.

A strategic and structural core problem of young enterprises is often the result of the largely exclusive focussing of the enterprise founders on sales markets and customers. The necessary *adaptation of internal processes and structures* is often neglected. In particular, typically internal routines and organizational practices in relation to external stakeholders are lacking [Aldrich (1999)]. It is typical for this phase in the development of a new enterprise that its turnover growth develops faster than the internal structures. Inefficiencies emerge in the structure of the organization, as all activities are concentrated on the founders who are often overburdened. The sustained generation of additional turnover growth requires therefore suitable strategies and the adaptation of the resource base and organizational structures which are required for further growth in the future. With the growth of the enterprise size, the degree of complexity in *processes and structures* increases. Additional **co-ordination processes** become necessary (e.g., re-organizing responsibilities in the daily management of the business). Founders and founder teams cannot dedicate themselves personally to these tasks. *The delegation of competencies and responsibilities* and thus an increased *trust in existing and new employees* become necessary.

According to empirical studies, various subsequent size levels are seen as critical thresholds for growing enterprises at which a *second level of leadership* must be implemented. Depending on the individual study and approach, the bandwidth of implementation of a second leadership level critical for managing the further enterprise growth, reaches from approximately 40 to 75 employees. Interviews have shown that entrepreneurs often become aware of a change in structures and processes within the enterprise from a staff number of approximately 20 employees upwards [Volkmann/Tokarski (2006b)]. A remark made by the founder of the media agency *Bassier, Bergmann und Kindler (BB & K)* [www.bb-k.com] from this study reflects the beginning of change in the internal structures of the enterprise:

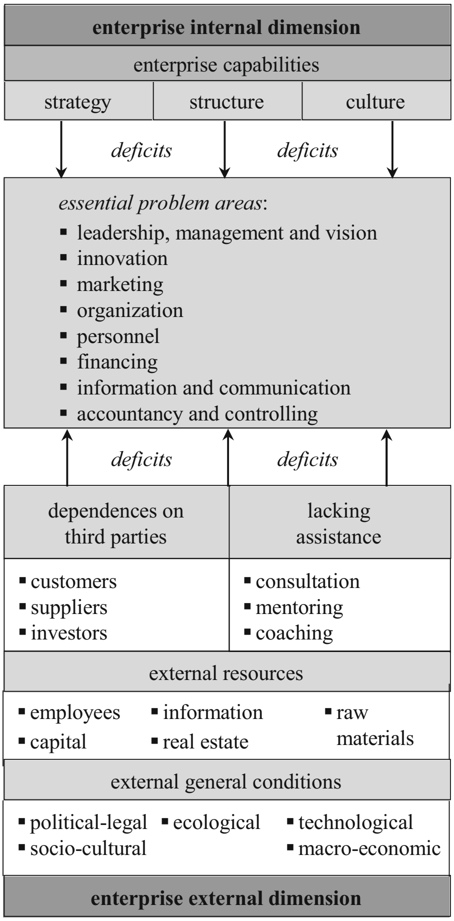
> *"From 20 employees onwards something changes." [Michael Bassier, BB & K]*

Irrespective of the exact threshold number of employees, growing enterprise size requires a higher degree of professionalism as regards internal organizational structures and processes. The founder persons are, therefore, sooner or later faced by the task of introducing a *second leadership level* to assign task areas and responsibilities, to delegate and to redirect information flows accordingly.

Many of the fast growing enterprises of the New Economy have fallen into a crisis in the USA and in Europe, or have even went bankrupt, because they neglected to plan growth and to create adequate structures which would have allowed a professional growth strategy. Within this context, a German example can be seen in the *EM.TV & Merchandising AG* whose founders acquired enterprises without a sound growth strategy and who, in the further course of the uncontrolled growth process with its subsequent crisis, had scarcely enough equity at their disposal to secure the survival capacity of their young enterprise. The immense slump in share prices as a result of the breakdown of *EM.TV* affected not only the staff of the enterprise, but also many investors. Finally, *EM.TV* could only be saved by a new management in a long process of reorganization and rehabilitation. There are, however, many successful cases in the New Economy. *Amazon*, for example, realized in the first years after founding a controlled fast growth and doubled its turnover in the first five years. *eBay* and *Google* have also grown with similar speed and success. These enterprises succeeded in harmonizing their strategies and structures with an extremely fast growth in size. Put simply, the only constant quantity in the development of an enterprise is change. If an enterprise renounces necessary changes, the growth can be compromised. Against this background, possible internally or externally conditioned deficits and potential problem areas of an enterprise will be examined in more detailed in the following.

The following Illustration 7-18 gives a survey of the most important *enterprise- internal and -external problem areas* and deficits of young enterprises with regards to growth.

*Illustration 7-18: Problem areas and deficits in the growth of young enterprises*




For enterprises oriented towards growth it is important that the enterprise founders or the management plan growth effectively and implement it actively. Growth must not be left to chance. **Goal-oriented growth planning** is *a necessary component of the strategic planning* of a young enterprise. In the following, typical problem areas of young, growing enterprises will be dealt with.

In the growth phase, the build-up or extension of different function areas may become necessary in the enterprise. In particular, young enterprises with founders from a technical (e.g., engineering) or academic background often have a strong, sometimes disproportionate focus on product innovations, for instance, in the form of further developments of the products offered or of the development of new additional products. Managerial areas such as the internal accountancy and controlling, personnel or marketing are neglected or, in an extreme case, not taken into account at all. These growth mistakes can lead to serious problems in the course of enterprise development.

## 7.5.2 Enterprise-internal Dimension

### 7.5.2.1 Leadership, Management and Vision

The founders or the management can be seen as a crucial factor for the success or failure of a young growing enterprise. **Problem areas** are usually caused by *lacking or insufficient competencies and wrong decisions of the enterprise founders.* The founders often overlook the fact that the demands on their managerial skills change in the course of the growth process, in particular during the transition from the start-up to the growth phase. The faster the enterprise grows, the more important it is that potential problem areas are anticipated early on in the growth phase, so that consequential growth mistakes can be avoided. In simple terms, it may be assumed that the *majority of all failures* of young enterprises are due to *wrong decisions or insufficiencies of the management.* However, in the individual case, a detailed cause-effect-analysis should be performed before concrete conclusions can be drawn, as the spectrum of possible causes for failure of young enterprises is wide and diverse. [There may even be failure trajectories of problems unfolding over time; Pasanen (2005). In this process management mistakes have an indirect effect on business failure or survival.]

If the *problem solving abilities* of the founders are in the foreground during the pre-founding and start-up phase, *leadership competencies* significantly gain in importance in the growth phase. When employees are acquired, the enterprise founders are increasingly challenged to apply their *leadership, motivation and communication skills.* Young enterprises usually prefer a co-operative leadership style which is less oriented on hierarchies and more focussed on jointly aspired enterprise goals. Not all enterprise founders, however, manage the transition from the start-up to the growth phase successfully, as they are often used to do everything themselves and do not have the necessary confidence that (potential) employees are as competent as themselves. Should the enterprise founders have crossed this critical threshold, *technical, innovation and methodical competencies* also play an important role in the growth phase as regards the extension of the business activity. The necessary **technical competencies** consist, in addition to the actual (technical) product competence, above all increasingly in the managerial areas such as controlling, marketing, distribution, personnel leadership and financing. The **innovation competencies** refer mainly to the *recognition of product innovations.* These capabilities may be a necessary condition for enabling growth practically. **Methodical competencies** refer in this phase primarily to *planning, decision and problem solving methods.* As with the growing enterprise, the leadership tasks which so far lay exclusively with the enterprise founder can no longer be adequately fulfilled by him or her alone. In other words, the employment of leadership techniques becomes more important. It is particularly important at this point to be able to delegate tasks. In addition, measures to increase the motivation and commitment of the employees become more critical during the growth phase.

Should the required technical, methodical and leadership competencies not be available in the enterprise, additional management talent must be employed. If this is financially not feasible, support must be sought from outside the business. In practice, it is often not easy for young enterprises to find suitable management staff, to build management competencies and to develop them further as required. Another possible problem area can also be the lack of vision of the founders. This is particularly critical since entrepreneurial vision constitutes an important mechanism (both internally and externally) to keep others committed to the enterprise [Lounsbury/Glynn (2001); also cf. Witt (1998)].

#### 7.5.2.2 Innovation

**Innovation** is also important for young enterprises, which want to generate growth. Problems may arise, for instance, due to lacking or insufficient innovation activity. It is often the case that young enterprises introduce only one product into the market at the beginning of their business activity. A successful product and marketing of this product often require the employment of all available resources, in particular with regard to personnel and capital. The capacities of the enterprise founders are also often completely tied into *the daily business operations.* As a consequence of a **strong demand of management and other resources** and a **concentration on daily business activities**, it can happen that *no resources are available* for the development of innovative follow-up products or that the necessity of planning new innovative products is not recognized or neglected [cf. Timmons/Spinelli (2004)]. **Lacking follow-up or replacement products** can in the long run lead to an *endangering of the growth of the enterprise* or may even threaten its existence. If only one product is on offer, the life-cycle of the enterprise is closely connected to the product life-cycle. If the life-cycle of the product comprises, for instance, seven years, it is conceivable that the enterprise will develop in analogy to the product life-cycle and thus runs in parallel to the product through a start-up, introduction, growth, stabilization and degeneration phase. If the product has already reached the maturity phase and no new, innovative products have been developed or have already been introduced into the market, this can be seen as critical for the whole enterprise. Against this background, an active, continuous innovation management should already be employed in young enterprises. [Recall the *BCG* portfolio matrix which suggested a balanced range of products in different life-cycle stages. While this may be difficult to establish at start for a new enterprise, founders need to keep track of the strategic implications of maturing products and market segments they operate in.]

Especially in technology-oriented new enterprises, the **complexity of the technology** must not be underestimated. It is a fundamental mistake, when the *time for the development* of the product up to market maturity *is assessed incorrectly.* However, the development to market maturity is only one aspect. For example, it may be difficult for growing enterprises to plan their production capacity as the demand for innovative products is difficult to forecast in the dynamic process of innovation diffusion into the market place. In the case of innovations which are based on complex technologies, the product benefit must be communicated to the customers in a clear and comprehensible way. A young enterprise has therefore not only to master the technological complexity itself, but must also solve the associated enterprise-internal and -external information and communication problems [Hauschildt (2004)].

In analogy to established enterprises, young enterprises too can employ various tools and **techniques of innovation management** such as, for instance, the *lead-user method* or *creativity techniques* to arrive at an innovation and work through the product development process in a purposeful and structured way. **Research and development co-operation projects with third parties,** as, for instance, *universities and colleges,* can also offer a possibility of generating innovative products.

### 7.5.2.3 Marketing

**Marketing competencies** count among the *critical success factors* of a young enterprise, above all in the growth phase. In the start-up phase, the distribution know-how and the personal contacts of the founders with individual customers may be sufficient to be successful. For an extension of the business activity, be it through expansion of the product range or the opening-up of new geographical markets, a professional **marketing** is important. This often implies the *establishment of a separate marketing department*.

**To recognize customer needs** and to focus on them, is the *necessary condition for the development of target-group specific marketing strategies* and thus for a successful marketing. Particularly in young, growing enterprises, feedback from the customers are usually not recorded and evaluated systematically (e.g., in a systematic complaint management). Frequently, *valuable indicators and ideas for product development come from the customers,* which are important for a young growing enterprise willing to distinguish itself from direct competitors in the market [for this form of "market learning" and its application by small business owners, see Willem and Broek (2007)]. In small, growing enterprises it may not be advisable to build up an in-house marketing and sales department due to lacking financial and personnel resources. In this case, it would be recommended to examine whether co-operation or licence partners can take over the marketing for the young enterprise. This would, however, include the risk that this might lead to the takeover of the enterprise by the co-operation partner who has the vital access to customers. Co-operation partners can also become competitors as soon as they have acquired the relevant know-how in the course of the co-operation project. A technology partner, for example, who works for advertising agencies, may perhaps be in a position to offer the service range of the advertising agency himself after a few contacts with key clients.

The multi-media agency *Bassier, Bergmann and Kindler (BB & K),* founded in 1998 in Oberhausen, Germany initially pursued the strategy of functioning as a technical partner and service provider for traditional advertising agencies, as the latter did not have the technical know-how at their disposal in the area of information and communication technologies. Bassier, Bergmann and Kindler realized the projects from the technical point of view, which had been planned by the advertising agency. However, gradually *BB & K* took over project management tasks in addition to the technical realization and thus the complete administration and processing of the order of the advertising agency, operating in direct contact with the client. In this way independent projects developed with clients which were not processed via the advertising agency. From the point of view of *BB & K*, this development can be seen as a growth strategy. For a young enterprise it can therefore be advantageous to establish contacts via a co-operation relationship and thereby achieve growth. Conversely, a young enterprise itself must face these risks when entering a co-operation. Consequently, the choice of adequate co-operation partners and the layout of contracts play an important role here.

Finally, there are typical market and customer related problems stemming from the rapid growth of customer demand and sales volumes. As introduced above, (production) capacities choices are difficult to make for entrepreneurs in cases where demand is uncertain. From the perspective of the customers, capacity shortages may compromise service and product quality, e.g., because of long delivery times. For service businesses in particular, it is often challenging to keep service quality consistent as the business grows in face of shortages of qualified personnel and the need to re-structure operations to adapt to growing demand, i.e., growing rapidly in the market also triggers needs for adapting the organization of the enterprise throughout the growth phase.

#### 7.5.2.4 Organization

Conventional organization structures often no longer suffice to meet the flexible requirements of growing young enterprises. An essential challenge for the management consists in creating **organization structures,** which meet the *internal* and *external* needs of the enterprise. Special attention has to be given to the *environment* in which the growing enterprise is operating. With increasing enterprise growth, the demand for a stronger structuring of the organization also often increases. If organization structures are completely absent, there is the danger that work is duplicated or not carried out at all due to the increasing confusion and lack of transparency. To avoid this type of problem, many growing young enterprises model themselves as simple *line organizations.* This approach is designed to promote a *clear assignment of tasks and leadership responsibility.* The challenge is, however, to meet the **need for flexibility and team**

**orientation** and not to generate a rigid organization structure. In this context, **project organizations** are gaining in importance for young enterprises which allow a *flexible reaction to enterprise-internal and external demands.*

Within this context, the necessity of **optimizing enterprise processes** is also to be considered. Insufficient transparency as regards operating schedules and business processes lead to an increased time expenditure and to problems in quality assurance. Therefore, *transparent and clearly defined business processes* are indispensable for growing enterprises. Where processes continue to repeat themselves over time, tasks can be fulfilled more efficiently through standardization and the development of organizational routines finally overcoming typical internal liabilities of newness.

#### 7.5.2.5 Personnel

An essential critical growth factor is the pool of talent, i.e., the employees of young enterprises. In internal growth strategies in particular, the *competencies and the motivation of the employees* are crucial for the success of the enterprise. A young enterprise usually faces the crucial question of how to acquire *qualified employees* and how they can be *lastingly* integrated into the enterprise. At the same time, young enterprises are frequently not so attractive at first glance to potential staff compared with established enterprises because of their higher risk and lack of reputation or image factor. However, some material and non-material (in particular non-monetary) **incentive systems** are available to young enterprises, which can prove to be advantageous for recruiting employees and building loyalty.

As a *monetary incentive* it is possible to let employees participate in the enterprise success, e.g., in the form of an employee stock option scheme. Young enterprises can also offer some advantages in *non-monetary aspects* to make them attractive for potential employees such as *flat hierarchies associated* with *open, communicative and co-operative leadership styles* of the enterprise founders, as well as *many and diverse task areas* and an intimate *business climate* offering good chances for development. In addition to the *"learning by doing"*, which is characteristic for young enterprises, the employees should also have prospects for further career development. This applies in particular to employees who show a high development potential. The **creation of incentive systems** becomes an essential factor in acquiring qualified employees and in preventing the exit of specially talented and valued employees in the further course of the growth phase.

When employing personnel it is to be ensured that the employees show a **heterogeneous age structure** in relation to the enterprise founders and the existing personnel pool [Dowling/Drumm (2003)]. In the case of founders who are still young, older employees with specific skills, experiences and management competencies can, for instance, have a supporting effect on the planned growth process of the young enterprise. If the young founders do not directly intend to employ senior personnel, the external support through consultants or, if additional capital is required, through *business angels* can be advisable.

In summary, a neglect of the personnel planning can endanger the desired growth of the young enterprise, in particular when important key employees leave the organization and who may even found their own enterprise, which will enter into competition with the young enterprise. Systematic planning, recruitment, development as well as the long-term involvement of employees are therefore necessary to ensure a sustained growth of the young enterprise.

#### 7.5.2.6 Financing

Growth mistakes under the aspects of financing lie mostly in the choice of *wrong financing strategies* and *financing instruments* (financing mix) as well as an *inadequate or wrong liquidity management* within the context of a usually too **low volume of equity capital**.

However, a strong enterprise growth normally requires substantial financial resources. The building-up of the required business structure, the employment of staff, the extension of production capacities and the opening-up of new markets generate a considerable demand for capital. In most cases, growth cannot be financed internally with the resources of the young enterprise due to lacking profits, or limited scope for personal self-financing by the founders [Shane (2003)]. Even if the founders try to break even at an early stage and achieve a positive cash flow, growth-oriented enterprises normally lack the necessary capital to finance the turnover growth to which they aspire. The possibilities for self-financing are, therefore, mostly limited or non-existent. Practical experience of enterprise founders, however, shows that the **availability of capital** (e.g., venture capital) is usually less of a problem for economically feasible and innovative business models (in particular for those enterprises which have already reached the expansion stage of development). The acquisition of external equity and debt capital becomes a problem for young enterprises mainly when the business model is unconvincing or the capital requirement is only insufficiently or incorrectly presented to potential investors. Also, there may be a problem of capital rationing with regard to seed and early stage funding of new ventures because of the high level of uncertainty implicit in new business models at this stage. Positively speaking, those enterprises which manage to obtain external funding appear to grow faster, e.g., in terms of employment [cf. the study of Westhead (1995) on UK high-tech enterprises]. Moreover, young and small enterprises with a small resource base find it harder to deal with adverse environmental conditions (e.g., a downturn in the business cycle) on account of their liability of smallness. Thus there is also a strategic element in the access to sufficient funding for young enterprises and their ability to withstand changes in the external environment. “New ventures with more capital are more likely to survive, grow and become profitable because capital provides a buffer that entrepreneurs can use to respond to adverse circumstances” [Shane (2003), p. 162].

A frequent **financing mistake** in the growth phase, in particular of founders from a technical, engineering or scientific background, is the failure to develop an adequate capital structure for the planned growth. In particular, it is a clearly expensive financing strategy to finance long-term fixed assets through short-term debt capital. Equally critical is the step-by-step amortization of long-term debt obligations by taking-up short-term credit. Such financing strategies can endanger the growth considerably. Moreover the *equity capital base of young enterprises is usually too small* and those enterprises with lack of sufficient equity capital may have the least chances to survive long-term [Lussier (1995)]. When the capital base of a young enterprise is only small, already minor wrong decisions of the founders or unforeseen intervening events can affect the *liquidity* of the business in such a way that the existence of the young enterprise is threatened. Empirical studies have shown that many enterprises are not familiar with the variety of available financing alternatives with regard to growth financing (e.g., business angels or mezzanine financing). The **spectrum of financing possibilities** goes far beyond the *personal resources of the founders, family and friends* as well as *bank financing and public support resources.* Practice shows that young enterprises in particular, which are financed by *VC enterprises or business angels,* usually have *comprehensive and professional planning and controlling tools* at their disposal. These are partly determined by the equity investors and checked subsequently on a regular basis. The creation of such added values should be taken into consideration by the enterprise founders in the choice of suitable strategies for growth financing.

To be able to counteract liquidity problems at an early stage and in good time, **liquidity planning** is essential. All *future occurring in- and out-payments* are to be shown as exactly as possible. For a *planning period of at least one year,* the **availability of liquidity** for individual months, weeks (or in certain business lines even days), is verified taking into account the term structure of external financial resources to the enterprise (e.g., existing credit lines). A continuous verification of planned cash budgets and a *systematic target-performance comparison* are necessary to achieve transparency and the opportunity for early counteracting measures. It is typical for enterprises in the growth phase that high costs are generated through expansion and focussing on additional market share gains. However, if sales remain behind expectations, this exerts a strong pressure on the liquidity as a whole [Rovenpor (2004)]. If the liquidity base of the young enterprise is small, there are special risks through *unexpected credit defaults* and *payment delays.* This danger is today very real due to a notable fall in the payment morale of customers, and high outstanding debts can result in a threat to the existence especially for young enterprises. Against this background, a regular routine in cash budgeting and preservation of a strong liquidity base as a buffer are of fundamental importance. Often a growing number of customer orders must be pre-financed with increasing turnover [Shane (2003)]. This applies above all to large orders. In this situation, the young enterprise should try to obtain pre-payments from the customer, an approach which is quite common, e.g., in the construction or consultancy industry.

### 7.5.2.7 Information and Communication

In growing enterprises, **information and communication deficits** often occur if the necessary structures are either missing or do not function. An informal working "on call" is no longer possible, when a critical enterprise size has been exceeded. Information and communication problems – e.g., incomplete information – lead in individual cases to wrong strategic decisions. However, in operational business activities too, well functioning information and communication channels are indispensable in order to avoid inefficiencies, e.g., due to work duplication or tasks not carried out at all. Moreover, communication problems can also jeopardize the market position of the enterprise because they may threaten product and service quality (e.g., due to delays in the internal handling of customer orders).

**Functioning organization and leadership processes** are a *necessary condition for establishing an effective and efficient information and communication structure*. The improvement of the flow of information and communication within the enterprise can mainly be supported by IT systems. Information and communication flows are possible from person to person, from person to machine and from machine-to-machine. It is important in this context that not only an information and communication flow between people is possible, but that the information flow of data in the form of the integration of different applications is also gaining importance and can become a significant factor, especially in increasing operational and cost-efficiency within a growing enterprise.

In this connection, the concept of **collaboration** can be useful for young enterprises. This involves setting up *an organized information exchange with the assistance of new (internet) technologies and other technical aids.* With different internal and external partners it can become possible to generate mutual added value using targeted information exchange. The condition for this exchange is that the participating partners pursue a common aim along an internal or external value chain. While *technological competencies* and technological knowledge are required, the *identification, modelling, simulation, management, supervision* and *integration of (business) processes and systems* are also significant.

The context of collaboration comprises different forms of computer applications and concepts, which contribute to an improvement of information and communication inside and outside the enterprise. Examples are **groupware/collaborative systems,** such as *Lotus Notes (IBM), Groupwise (Novell), Sharepoint/Exchange (Microsoft).* Groupware applications serve to *support co-operation relationships under the aspect of time and space,* depending on volume and type. The various software suppliers offer groupware systems with different function or application ranges. Typical standard functions are *e-mail, calendar, notebook* or an integrated *project management system.* By using internet technologies, these functions can be used from any location of the world, as long as a connection to the application server can be established. These systems thus facilitate an immediate access to, as well as processing of, data contributing to a target-related information exchange and communication. Through these basic functionalities, other **collaborative software solutions** or tools can be requested, such as *chat functions, SMS-dispatch, virtual forums and discussion boards, instant messaging, audio or audio-video conference solutions or desktop and data sharing* with which to support the information and communication of the enterprise. These software solutions are designed to provide information and to contribute to efficient information exchange. Moreover, it is possible to work together on concrete problems, e.g., in ad hoc project teams. For this purpose, software applications can be employed which facilitate a joint processing, provision and versioning of documents which are to be processed (in the widest possible sense documentation of the changes and access to the document history).

Moreover, there are also enterprise-wide collaborative systems for production development and **product-life-cycle-management systems** available, such as, for instance, from companies like *Dassault Systèmes, PTC, Oracle* or *SAP.* Such systems are designed to contribute to an integrated information and communication flow in the product development process. Depending on the definition of the product life-cycle approach, these systems try to connect with each other, that is, the collaborative design process, document management, product data management (e.g., administration of construction data), configuration management as well as the direct material procurement of a product within individual systems, to generate a data flow between the systems in order to generate an integrated optimized process.

To what extent individual software applications and concepts can be used and paid for by young enterprises must be examined in each individual case. The requirements made on systems, which are designed to encourage an efficient flow of information and communication, must be clearly specified. Information and communication technology can be applied to support existing processes of the enterprise, yet the same integration of a new system also offers the possibility to optimize processes. Ultimately, many different systems and concepts may contribute to an improvement of the information and communication flow to support entrepreneurial activities.

#### 7.5.2.8 Internal Accounting and Controlling

Empirical studies have shown that the failures of young enterprises are often due to lacking business experience of the founder persons as well as inadequate accounting and controlling systems [Bausch/Walter (2002); Dowling/Drumm (2003)]. Both the *external* reporting and the *internal management accounting* are indispensable conditions for a successful enterprise growth. Often, young enterprises do not know which of their products, services or activities are profitable in the end (namely because they do not do activity-based or product-based variable costing to find out which areas of the business contribute to the firm’s profits). As the enterprise founders often concentrate at first on customers and the generation of turnover, questions of economic efficiency and profitability only too often disappear in the background. To be able to direct and control enterprise growth, the **build-up of a controlling system** is necessary. Depending on the size and the growth prospects of the enterprise, a simple *break-even analysis* can at first be sufficient.

In addition, a *functioning cost calculation system* is required. The system must be designed in a way that information about the profitability of the sales activities, differentiated according to customer groups, products or regions, is obtainable. With the help of break-even-analysis and through target-actual performance comparisons, weak points and loss sources can be revealed [Dowling/Dumm (2003); Timmons/Spinelli (2004)]. In this connection it is also essential that in spite of the lack of time and resources, the founders or selected employees occupy themselves with the questions and requirements of external accounting systems and do not simply outsource these tasks to a tax consultant or auditor. Although outsourcing may lead to relieve the burden on the founders, no knowledge is built-up in this area which is a condition for establishing internal accounting systems.

Another area in which young enterprises often show deficits is the **management of accounts receivable.** Because of the often slim resources during the growth process, it is necessary to collect claims resolutely. When reaching a critical turnover threshold it must also be checked from a perspective of liquidity management in how far the sale of claims to a factoring company can be considered.

Within the framework of controlling as well as claims management, different IT applications and concepts can be employed. The spectrum of possible software programs reaches from small, cost-effective solutions such as, for instance, *Lexware financial office pro* (Germany) or *Abacus* (Switzerland) for small and medium sized enterprises up to highly integrated enterprise-resource-planning systems, as are, for example, offered by *SAP.* These systems are today no longer seen as isolated from each other. An integration of most system types can be envisaged which will allow a generation of a comprehensive current data base for a target-oriented controlling system.

Within this context, not only a controlling system based on financial figures is important. It is recommended to build-up an **integrated controlling.** In particular it has to be asked: "Are accounting and information systems and control (purchase orders, inventory, billing, collections, cost and profit analysis, cash management etc.) keeping pace with growth?" [Timmons/Spinelli (2004), p. 563]. For example, for marketing purposes an integrated control system may facilitate the registration of customers, customer groups, customer structures, purchasing behaviour and customer relationships. Within the framework of *Customer Relationship Management (CRM)* relevant requirements can be supported and carried out by software provided, e.g., by *SAP*, *Oracle*, *Microsoft* or *SugarCRM* (open source). Many CRM systems are first employed primarily in distribution or marketing to care for customers, to win new customers and to support marketing activities. These systems should, however, not be used isolated from other systems but in the context of an integrated controlling system. Within an integrated controlling it is advisable to access information from different enterprise areas and to be able to network them with each other. Within product development and product controlling, *product life-cycle management systems* can be employed, the data of which can be used for an integrated controlling system. In principle, many information- and communication/technical systems can be utilized for controlling. The problem is however that the data are available in individual, separated systems. When making efforts to establish an integrated controlling system, a *data-warehousing* approach may be useful. In principle, a *data warehouse* represents a database which is composed of different individual systems of internal and external data or data sources. These data are extracted from other (productive) systems, pre-processed via different transformation steps, structured and finally transferred or loaded into the actual data base, the data warehouse (so the process is called ETL – extract, transform, load). When integrating internal, external, distributed as well as differently structured data, a global view of the data is first of all generated. Starting with this general, global point of view, various evaluations can be generated from the data warehouse (e.g., to identify patterns in the buying and payment behaviour of customers over time). To analyse the data or to generate retrievals, different structured or semi-structured techniques, functions and concepts can be used such as the *Data Mining* or the *Online Analytical Processing (OLAP).*

For young enterprises, there are many and diverse possibilities to use controlling tools and supporting information and communication technology, which can facilitate the planning process throughout the growth phase. It is essential that a young enterprise finds a controlling solution which is suitable for its specific needs to be in a position of managing growth purposefully.

## 7.5.3 Enterprise-external Dimension

### 7.5.3.1 External Framework Conditions

An essential part of the structural change of an economy occurs through the processes of founding, growth and decay of enterprises, and young, growing enterprises are indispensable for a well functioning economy. For the growth of young enterprises it is important to have **reliable framework conditions,** which facilitate sound enterprise development. These include primarily the *prevailing political, legal and economic conditions.* In a market-oriented economy, the state has the task of creating positive framework conditions for entrepreneurial activities. However, these framework conditions can normally not be influenced by an individual enterprise. In particular, small and new enterprises will typically not be in the position to actively change environmental conditions and restrictions [cf. Curran/Blackburn (2001); Maguire et al. (2004)].

Founders and young enterprises often judge critically *time-intensive requirements* made by authorities and administrations [cf. Ho/Wong (2005)]. **Bureaucratic obstacles**, especially in the start-up but also growth phase, signify a considerable *disadvantage for certain business locations (e.g., Germany)* [cf. Klandt et al. (2008)]. For example, such obstacles and excessive regulatory business costs may include too-long waiting times for licences and permissions or bureaucratic burdens in the area of labour legislation. As regards the **dismantling of bureaucratic obstacles and handicaps** for young enterprises, there is still a *considerable need for political action.* What is, however, the situation with regard to the tools for promoting young enterprises?

#### 7.5.3.2 External Resources

The lack of **external resources,** such as *employees, capital, information, real estate* or *raw materials,* can be another reason for problems in the growth process of young enterprises. Market entry or growth barriers can have been built up by competitors, which restrict or prevent the access to special external resources (exclusive supply contracts for a specific product can be named as an example in this context). Therefore, it is important to recognize potential barriers which may hinder external growth, and to develop a suitable evasion or compensation strategy.

An *unhindered access to capital* is essential for the growth of an enterprise. Growth needs capital, be it for the development of new products, for marketing or the employment of new staff. For young enterprises in the growth process it is, however, often difficult to generate sufficient cash flows for internal financing. In many cases, young enterprises initially generate only losses over a number of start-up months or even years (depending on industry sector), until the break-even point is reached. Young enterprises must thus rely on external financing, be it financing in the form of equity, debt or mezzanine capital. Within this context, the problem of financing young enterprises via banks and other institutional lenders exists, as young enterprises usually do not have sufficient collateral to offer.

#### 7.5.3.3 Dependencies on Third Parties

**Dependencies on individual large customers or suppliers** *can scarcely be avoided in the start-up and growth phase* and serve during the start-up years to assure the survival of many enterprises. Thus, specific dependences on strategic partners or networks can have a *positive* effect on growth at the beginning. If, however, a young enterprise would like to take on external capital, it has normally to face the critical assessment by investors and lenders in this respect. Within the framework of **credit checks** of banks, *dependencies of an enterprise,* be it on the sales market, on the procurement market or with regard to co-operation partners (e.g., licensers) lead to a *deterioration of the credit rating.* Dependencies of the young enterprise become mainly problematic, if conflicts with the main customers or main suppliers occur over time, which lead to a short-term cancellation of existing contracts. Moreover it is a problem if main buyers or main suppliers get into difficulties themselves or even become insolvent. As soon as orders of the main suppliers fall, the young enterprise enters a growth crisis, which can turn into a threat to its existence, if it is not possible to acquire in good time new orders from other customers. Against this background, the critical view of the external financiers is completely understandable.

There is, however, in young enterprises also the possibility of a **dependence on capital providers.** The higher, for example, the share of a venture capital investor in an enterprise, the greater are also its information, voting, control and co-determination rights. In this way, the enterprise founders can progressively lose their scope for action and managerial independence. In short, when planning its growth, the young enterprise must be aware of all potential dependencies on certain stakeholder groups and weigh up their advantages and disadvantages with a view on the required future strategic decisions.

If dependencies are unavoidable in the first few years of the life of an enterprise, they should, however, be gradually reduced with increasing growth. If the generation of a permanently large order volume can be ensured, the build-up of self-marketing, production and development capacities may be advisable. These can then lead to a *decrease in the degree of dependencies of the young enterprise.* If dependencies on strategic partners or networks lead to growth barriers and increased risks for the young enterprise, it must try to reduce them through the **extension of the customer or supplier base.** In co-operation projects within networks, the homogeneity of interests must be ensured in order to minimize any growth-hindering transaction costs [Dowling/Drumm (2003)].

An example for a young innovative enterprise, in which practical dependencies on two big customers exist, is the US-American enterprise *Transitive* [www.transitive.com] which was founded in 2000. The software technology developed by Transitive allows the running of programmes specially compiled for a specific processor or a special operating system, on another processor or operating system without the need of making changes on the source code of the software. Transitive has an innovative technology, but has been dependent on two big customers, the workstation manufacturer *Silicon Graphics* (SGI) and *Apple* (which used the Software within MacOSX for its transition from the PowerPC-microprocessor-architecture to the Intel-x86-architecture). Additional dangers of dependence on third parties lie, for instance, in a potential insolvency of one of the customers or in the possibility that one of the two customers will develop its own technology using the co-operation only for a transitional period. One customer may also be interested in taking over the enterprise because of its innovative technology (in this case Transitive was acquired by *IBM* in 2009).

These dependencies can originate within the framework of **licensing.** It is therefore important to ensure that no over-dependencies are created when building one's business model on licensing. Irrespective of whether a direct licensing or marketing through a co-operation enterprise is carried out, different problems can emerge for the licenser enterprise. By the application of the licence technology, the licencee also acquires his own know-how through the application of the technology, a situation which may lead to a strategy aimed at developing one's own technology and to cancel the licence agreement. Under observance of the industrial-protection rights such as patents, the licenser can himself become a technology producer over time, either through his own developments within the framework of internal growth or by acquiring technologies within the framework of external growth strategies, e.g., by acquisition. A typical example is *Yahoo!*. For many years, *Yahoo*! was a licencee of the search technology of *Google* until *Yahoo*! employed the so-called *Yahoo*! Search Technology in its offers. The *Yahoo*! Search Technology is a further development of the technologies which were taken over with the acquisition of *Inktomi* and *Overture*. Through the loss of *Yahoo*! as a licencee, the continuation of the *Google* enterprise is admittedly not at risk, as *Google* has many other licencees and other business areas at its disposal. This situation leads, however, to a revaluation of the market shares and therefore also of the online-competition market. *Yahoo*! is now a direct competitor in the area of search engine technology and offers an online search from one base.

As this example makes clear, it becomes evident that licences or strategic partnerships are in most cases designed for only a limited period of time and can be considered as a partnership of "convenience" in growth. It is important that a dependence on a few licencees or even a contractual exclusivity is not entered into, especially if the technology is still unknown at the beginning and it may not be possible to assess its market potential correctly.

#### 7.5.3.4 Lacking External Support

In many countries, there is a wide range of **public-support instruments for new businesses** available in the context of public enterprise policy. As far as funding is concerned, these are programmes for strengthening the equity capital basis and access to debt sources by making available external capital and improving the position of new and young enterprises to attract external funding from the capital market [Storey (2003)]. These programmes are not designed only for start-up enterprises, but also for enterprises involved in a growth or turnaround process. Through public-support programmes, start-up enterprises and enterprises involved in growth have in principle the opportunity to access financial resources. Within the founding context in particular, there are many additional offers of support for founders, be it entrepreneurship courses at various education institutions or special workshops for drawing up a business plan. However, while there are many support offers available in the foundation phase, young enterprises often miss possibilities for individual consultation and external expert mentoring in the growth process.

Practical experience has often shown that, in addition to the comprehensive support and consultation offers for newly founded and established enterprises, *offers tailored to the specific problems and needs of young enterprises in the growth phase* are also required, as especially in this critical phase of development young enterprises often fail. Young, growing enterprises need an adequate and competent coaching and mentoring-support process related to their special challenges and problems, be it in marketing, financing, organization or human resource management. Often, neither banks, chambers of commerce nor other consulting agencies are in a position purposefully and in detail tackle the numerous and specific problems of young enterprises. This is because consultation and coaching services in the growth phase require a high degree of experience, technical competence and time. In contrast to start-up seminars, which are often organized in similar patterns and are relatively easy to reproduce and to explain, the consultation in the growth process is a complex subject area requiring a tailor-made approach to each individual enterprise case.

Approaches for mentoring enterprises in the growth process do exist in some areas, but there is further potential to be explored. One form of help for growing enterprises could be in the form of *mentoring* or *coaching.* In **mentoring**, an experienced person, the mentor, passes on his or her knowledge and skills to a still-inexperienced person, the mentee. The aim is an *encouragement of the entrepreneurial and personal development of the mentee.* The concept of mentoring therefore diverges slightly from the concept of coaching, as the *mentor, in contrast to the coach, is not a neutral person.* The mentor becomes very involved with the mentee and takes on an active role. In the promotion of young enterprises, mentoring can make a positive contribution within the framework of growth, as on the one hand the mentees, the founders or entrepreneurs in young enterprises, will profit from the experience of the mentor. Problems can be solved because the mentor also functions as an active advisor. On the other hand, it is also helpful for an entrepreneur to be able to talk about entrepreneurial opportunities and risks, strengths and weaknesses, strategies or personal problems.

Somewhat different in methodology if not goals, a **coach,** who takes a *neutral position,* can help the entrepreneur to solve problems on his/her own. It is, however, difficult to find the right mentor or coach, as a basis of trust must first be created. If the mentor or coach is also expected to give technical advice, it is sometimes difficult to find a suitable mentor. In this context there is still a great potential of support waiting to be developed.

In addition to the tools of mentoring and coaching, it seems also meaningful to develop further **institutional consulting services** *for young enterprises in the growth process.* It is important in this context that young enterprises can use external consulting services at an early stage and at reasonable cost. For qualified external support measures it can have a positive effect on the achievement of a long-term sustained growth of young enterprises. It is especially the young, growth-oriented enterprises which contribute in a unique way to the innovative power and dynamic development of an economy. Growing young enterprises not only form the basis for the existence of the founders themselves, but also for employees by creating new jobs.

# 7.6 Comprehension Tests and Recommended Literature

## Comprehension Tests

- Systematize the different growth forms. (7.1.1)
- Discuss the applicability of the life-cycle model and the concept according to Greiner for the description of the growth of young enterprises. (7.1.3.1)
- What influence can a vision have on the growth of young enterprises? (7.2)
- In how far can the BCG matrix serve to develop strategies for young enterprises? (7.3.1)
- Describe potential growth strategies and discuss the advantages and disadvantages of the individual strategy types for young enterprises. (7.4)
- Describe the employment possibilities as well as advantages and disadvantages of internal, external and co-operative growth strategies for young enterprises. (7.4.4)
- Discuss the concept of due diligence as well as the possible forms of enterprise valuation. Why is the valuation of young enterprises so difficult? (7.4.4.2.2)
- Discuss the importance of networks for young enterprises, including the different network relationships. (7.4.4.3.1)
- Discuss the concept of the strategic alliance for young enterprises, considering also the opportunities and risks. (7.4.4.3.2)
- Discuss the advantages and disadvantages of franchising for young enterprises. (7.4.4.3.4)
- Describe the concept of collaborative technologies and discuss their potential for young enterprises. (7.4.5)
- Discuss the statement that an enterprise should "not let itself be dominated by its growth". (7.5.1)
- Discuss essential internal problem areas of the growth of young enterprises and work out strategies to avoid them. (7.5.2)
- Describe the essential external problem areas of the growth of young enterprises. (7.5.3)

## Recommended Literature


### Growth – Standard Works

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### Growth models

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