

**A strategy to meet the challenges of entrepreneurship: The dotcom boom and bust has left many businesses wondering whether it is even worth trying something new. Donald Sull offers six disciplines to help innovators manage risk;; [London edition]**

*Sull, Donald. Financial Times. London (UK): Aug 12, 2002. pg. 10*

The Roaring Nineties were boom times for entrepreneurs. The venture capital flowed, the hype was loud and everyone wanted to get in on the act. Then came the hangover, and it was severe. In the aftermath, many people are asking themselves whether the boom was all smoke and mirrors without underlying economic substance. As investors, employees and customers rush back to the security of established enterprises, some even question whether entrepreneurship in general is a scam.

A little perspective is in order. The dotcom boom and bust is only the most recent example of a recurring cycle in economic history. Technical, regulatory or demographic changes periodically allow people to do things in new ways. Hundreds or thousands of entrepreneurs pursue related opportunities. Some succeed, creating tremendous value. Most fail and sink noiselessly into obscurity.

In the first decades of the 20th century, more than 400 entrepreneurs created new companies to manufacture car tyres. By 1920, the industry had produced 122 millionaires in a single city. Then came the shakeout. Within a decade, the five largest producers controlled 80 per cent of the market. This cycle has happened before and it will happen again.

The dotcom boom and bust did remind us, however, of one enduring truth about entrepreneurship - it is a risky business. Entrepreneurship consists of pursuing opportunities by trying something new. The more novel a venture is, the harder it is to predict how things will turn out. They can go very well or they can go very poorly.

In some cases, entrepreneurs can anticipate the risks: Will the technology work? Will the customers buy the product? Entrepreneurs must also contend with things they do not know they do not know. These unknowns - the questions the entrepreneur did not even think to ask - can prove deadly.

The most effective way to deal with risk is to acknowledge it exists, accept it as an unavoidable aspect of entrepreneurship and actively manage it. I use the term "disciplined entrepreneurship" to describe six mechanisms to manage risk actively.

Screen opportunities No opportunity is risk-free. However, entrepreneurs can often distinguish between manageable sources of uncertainty and deal-killers by vetting the opportunity before putting their time, money and credibility on the line. An entrepreneur's plan - whether it is an ill-formed notion or a 200-page business plan - resembles a scientist's working hypothesis.

The entrepreneur's hypothesis posits that, if they try something new, they will create value exceeding the cost of the resources they need. Like a scientist, the entrepreneur

can identify and analyse underlying assumptions before conducting an expensive experiment in the real world.

Much of this screening takes place informally through discussions with friends and colleagues. There are, however, more structured ways to vet an opportunity. Entrepreneurs can ask themselves a series of simple questions to highlight flaws in their idea (see below).

Entrepreneurs can evaluate their assumptions against their experience, other people's opinions and common sense. Translating a written business plan into a spreadsheet model of pro forma financial projections forces an entrepreneur to make explicit assumptions about the variables that drive cashflow, such as sales growth and customer acquisition costs. Can both these assumptions be true at the same time?

Match money and opportunity Money can not buy love but cash is the ultimate hedge against an uncertain future. Cash buys time and any other resources needed to respond to unforeseen changes. Remember, though, that all investors are not created equal. Friends and family, business angels, venture capitalists, incubators and corporate investors differ widely in what they bring to the table in addition to money. Investors can bring contacts, expertise in an industry, experience in building a start-up and credibility.

Potential investors also differ in their appetites for risk. Seasoned venture capitalists can live with 70 per cent of their portfolio companies sputtering along or even failing outright, as long as the other 30 per cent succeed. An entrepreneur's brother-in-law may look at failure very differently. Investors also differ in what they expect as a reward for bearing the risk. The venture capitalist looks for rapid growth and an enormous upside, while the brother-in-law may want nothing more than a reasonable return and something to talk about at the country club.

The costs of a mismatch between an opportunity and the investor can be disastrous. One start-up producing all-natural hair products, for example, could have been a nice regional business. Instead, the founders accepted money from a group of investors who wanted big returns and rapid growth. They expanded nationally to get big fast, taxed their limited resources and ultimately went out of business.

Entrepreneurs also need to consider their own preferences. How much control am I willing to give up? Would I rather get rich with my investors or remain king of my own domain? What level of risk can I live with? Could I personally guarantee a loan and still sleep at night? Stage experiments Entrepreneurs stage experiments whenever they try something on a small scale or reduce a major source of uncertainty before committing resources. Investors often require entrepreneurs to stage experiments. Venture capitalists, for example, generally dole out funding in successively larger rounds of financing while reserving the option to pull the plug if the experiments reveal bad news. Most entrepreneurs run experiments intuitively. They hire employees as consultants before bringing them on full time or they develop crude prototypes before designing a full-blown product.

When entrepreneurs recognise that they are conducting experiments, they can actively design and run them to increase effectiveness. They can, for example, begin with

inexpensive tests on important sources of uncertainty. Consider a large building project in which thousands of things can go wrong and right. Experienced developers begin by conducting an environmental assessment. These tests are relatively cheap and, if the land has environmental problems, there is no point in proceeding.

Targeted experiments work well when an entrepreneur understands how to obtain the missing information. But what about situations where an entrepreneur is ignorant of the risks? In these situations, an entrepreneur can run experiments that test the entire plan on a small scale. For example, they might choose to launch in a regional market before rolling out nationally or working with a representative customer to develop a prototype.

Before running experiments, entrepreneurs ask themselves a few questions: Has anyone run this experiment already? What did they learn? Can we run this experiment cheaper? Can we run it faster? Could we convince someone else, say, a customer or an alliance partner, to subsidise this experiment?

Write good contracts Entrepreneurs enter into contracts all the time. Some are formal documents such as term sheets, employment agreements and leases. Others are informal deals with employees, investors or partners. These "handshake" deals can be every bit as binding as formal documents, since courts will often enforce implicit contracts. Even if they would not, the cost of a damaged reputation may induce the entrepreneur to honour their word.

Contracts can be a powerful tool for managing risk. The process of negotiating a contract, particularly with experienced counsel, can alert an entrepreneur to things that could go wrong or that had never occurred to them. Even reading a simple document such as a commercial lease can be an eye-opening experience for someone who has never considered the things that can go wrong in renting space.

Before entering into a contract, an entrepreneur should ask a few basic questions. How many of these contracts have I written in the past? How many has the other party written? (If there is a big gap, you need help.) Do I understand everything in this contract? Can I separate the critical clauses from the peripheral ones? If I could change only three terms in this contract, what would they be? The devil is in the details but the trick is figuring out the details that matter.

Assemble a team People often picture the entrepreneur as a solitary figure, toiling away in the obscurity of a garage. In fact, entrepreneurship is very much a team sport. The most effective entrepreneurs surround themselves with people who complement their strengths and offset their weaknesses. Like investors, team members can provide much more than their labour. Each early recruit is critical: they represent a large percentage of all staff and help define the culture of the venture in the future.

In assembling teams, entrepreneurs should consider all the people they can call on for help, not just those people who directly report to them. Entrepreneurs might visualise themselves as standing at the centre of a series of concentric circles, with their immediate team around them. The next circle consists of formal advisers, including the board of directors, lawyers, accountants and paid consultants. The outermost circle consists of other stakeholders, including investors, customers and suppliers, all of

whom can help the entrepreneur manage risk. Before hiring someone, ask: What gaps do they fill in the team? Industry expertise? Start-up experience? Who do they know? Who knows them? Do they share our values?

Forge partnerships To execute their plan, entrepreneurs must often form partnerships with other companies that control required resources, such as a brand, technology or access to distribution. Collaborating with established companies can be a matter of life or death for start-ups, yet many entrepreneurs struggle to forge and manage these relationships. At one extreme, they try to do everything in-house, spreading limited resources too thin. Or they rush willy-nilly into partnerships with any company that will say yes, without fully evaluating the value of the relationship in business terms.

Entrepreneurs can bring discipline to the partnering process. They should decide on those activities to do in-house and those to outsource. Drawing the value chain of all the activities and resources needed to pursue the opportunity can help focus on what the company should do, identify gaps in the chain and suggest criteria for evaluating partners to fill those gaps.

In structuring partnerships, entrepreneurs can choose from a spectrum of deal forms, from loose licensing agreements to enduring joint ventures. This raises important questions. What are we trying to accomplish? How do we get there? How will we structure the governance? What milestones will we set along the way? And, finally, how do we get out? What do we do if things go well? If things go poorly?

I call this approach to enterprise and risk "disciplined entrepreneurship". Of course, there is more to entrepreneurship than discipline. The creativity to invent things, the passion for a vision, the grit to make it happen. Discipline and entrepreneurship are not the same thing. But neither are they incompatible. This is important to bear in mind as we edge towards the next wave of enterprise.

Five questions to ask:

- \* What is the phrase that pays? The discipline of describing an opportunity in a short phrase forces the entrepreneur to strip away the peripheral aspects and distil an opportunity to its essence.
- \* Why is the opportunity still here? If it's such a great opportunity, why hasn't someone done it already? Maybe it's too early.
- \* What has changed to give rise to the opportunity? Entrepreneurs need to point to specific changes in the competitive, technical or regulatory environment to explain the origin of their opportunity. They need more than the simple desire to be an entrepreneur.
- \* What pain are you solving for the customer? Opportunities to solve a customer's pain are often more robust than those that address less pressing desires.
- \* How big is the market? It is often difficult to forecast the market for a new product or service with precision. However, back-of-the-envelope calculations can provide a rudimentary estimate of market size and provide a check on overblown ambitions.

