

# Entrepreneurship

A Guide for Growth-Oriented Entrepreneurs

Sample Chapter:  
Managing Emerging Companies—Critical Success Factors and Challenges

**GROWTH-ORIENTED ENTREPRENEURSHIP PROJECT**

2015-1 Edition  
Dr. Alan S. Gutterman

## **Growth-Oriented Entrepreneur's Guide to Entrepreneurship**

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### **About the Project**

The Growth-Oriented Entrepreneurship Project ([www.growthentrepreneurship.org](http://www.growthentrepreneurship.org)) engages in and promotes research, education and training activities relating to entrepreneurial ventures launched with the intent to achieve significant growth in scale and value creation through the development of innovative products or services which form the basis for a successful international business. In furtherance of its mission the Project is involved in the preparation and distribution of Guides for Growth-Oriented Entrepreneurs covering Entrepreneurship, Leadership, Management, Organizational Design, Organizational Culture, Strategic Planning, Governance, Compliance, Finance, Human Resources, Product Development and Commercialization, Technology Management, Globalization, and Managing Growth and Change.

### **About the Author**

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This is a sample chapter from Part II of this Guide and you can get your full copy of the Guide and/or other sample chapters by contacting the Growth-Oriented Entrepreneurship Project ([www.growthentrepreneurship.org](http://www.growthentrepreneurship.org)) at [agutterman@alangutterman.com](mailto:agutterman@alangutterman.com). The Project also prepares and distributes other Guides for Growth-Oriented Entrepreneurs covering Leadership, Management, Organizational Design, Organizational Culture, Strategic Planning, Governance, Compliance, Finance, Human Resources, Product Development and Commercialization, Technology Management, Globalization, and Managing Growth and Change.

Attorneys acting as business counselors to growth-oriented entrepreneurs who are interested in forms, commentaries and other practice tools relating to the subject matter of this chapter should also contact Dr. Gutterman at the e-mail address provided above.

# PART II

# EMERGING COMPANIES

## Preface

It has become common to refer to technology-based entrepreneurial ventures as prospective “emerging companies” in large part because of their emphasis on, and potential for, high growth in both employment and revenues. While the term “emerging company” is now frequently used, particularly among professional firms and venture capital investors, there is still no widely accepted definition of the term and the characteristics of the firms that might fall within the scope of the definition. One place to begin in developing a working definition of “emerging company” is to recognize that it does not necessarily include every situation where one entrepreneur or a team of entrepreneurs attempts to overcome the trials and challenges that arise during the very earliest stages of conceiving and starting a new business (i.e., the “concept” stage). At a minimum, eligibility for emerging company status requires that the “next great idea” must have left the garage or the laptop in the attic and landed in its own discrete working space with human and financial resources obtained from outside the founder group. This is not necessarily an easy hurdle to overcome and it has been estimated that a large percentage of new firms are driven out of business before they reach their first anniversary.

Not all of the companies that survive the start-up phase would be considered “emerging.” It is instructive to note that the terms “emerging company” and “emerging growth company” are often used interchangeably and this provides an important clue in distinguishing the types of firms that are of interest to us—in order to be an emerging company the resource base and organizational structure of the firm must be suitable for sustained growth and the founders, other senior managers and outside investors must have all targeted growth and expansion as a key goal in the overall strategy of the company. In addition, emerging companies are built on the assumption that the desired growth will come from some new and unforeseen development that totally changes the dynamics of the market in which they are competing—technological breakthroughs, dramatic shifts in the costs associated with satisfying existing consumer needs, identification of new consumer needs and/or sociological or economic changes. It is the job of the managers of the emerging company to embrace and exploit these developments by identifying business opportunities and creating new products or services to take advantage of them.

Emerging companies are often distinguished from the broader set of entrepreneurial activities by focusing on the significant level of “innovation” associated with their business models. Researchers have attempted to identify those firms that have been most successful at innovation, and to describe and explain those business practices that tend to be associated with innovative companies. Presumably a listing of these practices can provide valuable clues for identifying emerging companies and the factors that are the

best predictors of success. A survey of the research results relating to innovation reveals the following:

- Innovative companies have strong leaders that are able to clearly articulate a vision for the business, set targets and create and maintain open relationships with all stakeholders (i.e., customers, investors, suppliers and employees).
- The most innovative companies have extensive knowledge of the marketplace, the needs of customers, and the strengths and weaknesses of their competitors.
- Innovative companies seek and retain extraordinarily qualified personnel, provide them with the proper amount of resources and general direction, and then allow them to make and pursue their own specific strategies for achieving the agreed goals.
- The organizational structure of an innovative company emphasizes integration of multiple disciplines and functions and teamwork, goal sharing, and full and effective communication of goals and objectives throughout the firm.
- Technology is used effectively throughout the company, including small changes in design, production processes and customer services.
- The company strives and plans for continuous and constant innovation, as opposed to isolated new ideas, to improve and enhance products, services and productivity.
- Innovative companies strive for strong brand recognition and rapid introduction of new products and services into the marketplace.
- Innovative companies have systems for collecting information about, and learning from, customers, competitors and unrelated businesses around the world.

The research also identifies some of the most common specific strategies for innovation:

- Frequent implementation of new management techniques;
- Implementation of skill development and education programs for managers and employees;
- Regular introduction of new technologies, generally no less frequently than every three years;
- Constant and systematic benchmarking through regular comparison with the best companies in the industry and elsewhere;
- Significant investment in customer-focused product design and in quality-based manufacturing equipment and processes;
- Regular changes in the organization of work and administration, typically made in conjunction with the introduction of new products and/or technologies;
- Allocation of a significant share of turnover, generally at least 10%, to development and introduction of new products and processes; and
- Collaboration with universities and other research centers to identify technologies which can be converted into profitable products and processes.

It is now generally accepted that innovation is essential to continued productivity and economic growth; however, innovation in the form of uncovering a new technological breakthrough is not necessarily as important as how and when the technology is reduced to practice and diffused into the marketplace in the form of new or improved products

and services. Successful emerging companies realize that the growth that they are pursuing must come through continuous creation, implementation and refinement of innovative business models and that the leaders in emerging markets will be those firms that can innovate—the companies that are successful in creating, acquiring and/or combining technology and other knowledge into new products, services or business processes faster and more efficiently than the competition. Many companies stall out and are unable to break through size and revenue plateaus because they are unable to keep their innovation engines churning. In order to be a successful emerging company a firm must constantly challenge their status quo and seek innovation with respect to its products and services and the processes that are used to add value for customers and other stakeholders.

This Part discusses various definitions and characteristics of emerging companies, the relationship between emerging companies and innovation, critical success factors for emerging companies, challenges to growth generally experienced by prospective emerging companies, growth models for emerging companies and strategic alternatives for emerging companies. Emerging companies can initially be distinguished by the current and projected financial performance of the company—measured by revenues, sales, profit margin, cash flow, etc.—to determine whether the business has been, and will be, generating steadily increasing revenues at above-average rates; however, it is also important to examine whether the company has the resources and strategies in place to grow rapidly. Critical success factors for emerging companies can be broken down into two main groups: “internal” factors, which focus on the characteristics of the particular company and its founders and senior managers which can usually be affected by the company itself; and “contextual” (or external) factors, which focus on the organizational environment in which the company is operating and generally exist independent of the activities of the company although management generally has some discretion in defining key elements of the organizational environment in which the company will be operating. The Part also includes an introductory chapter on emerging companies in developing countries, an interesting phenomenon that challenges both local entrepreneurs and policymakers in those countries to create tools and strategies for accessing the essential universal requirements for emerging company status: technology, products, markets, distinctive competencies and managerial acumen with a growth-focused orientation.

## **Chapter 2**

# **Managing Emerging Companies: Critical Success Factors and Challenges**

### **§2:1 Introduction**

Emerging companies, particularly when they are at their earlier stages, have a number of strengths that distinguish them from larger companies. Among other things, the founders and other managers of small emerging companies often demonstrate exceptional determination to be successful, creating an enthusiasm that permeates the entire organization. In general, the innovation process is much more rapid in these firms and



they are generally able to respond more quickly to customer needs. In many cases, initial success is achieved by identifying and servicing niche markets that have been ignored by larger companies. Smaller firms can also thrive by taking on jobs that are considered to be too small for bigger businesses.

On the other hand, some of the very characteristics that create opportunities for small emerging companies can endanger their survival. For example, the limited resources and day-to-day pressures of launching a new business often leads to a short-term focus and neglect of the investment in human resources necessary for long-term success and stability. Small firms may also become too reliant on a small group of customers. Cash flow is another common problem for firms in the early stages, since they are particularly vulnerable to order stoppages and slow payment by a single customer and generally experience difficulties in finding capital required for expansion on reasonable terms. Finally, while governments are attempting to reduce the regulatory burdens confronting small businesses, the time and costs of compliance are still disproportionately high for companies of this size.

Small businesses engaged in technology-related innovation face additional challenges above and beyond the hurdles confronting other small firms. For example, they must find a way to collect development capital to complete the work necessary to move into the production and diffusion phase. This is often problematic in that such firms must survive for substantial periods with revenues from commercial activities. Also, success in this type of venture requires an unusual mix of technical and managerial abilities that differ from the generic group of small businesses. In particular, the ability to effectively transfer technology developed in a science-based environment into new commercial applications is essential to the growth of innovative technology firms. Finally, small technology-based firms tend to be more reliant on networking relationships with other firms and organizations (e.g. universities) having complimentary resources.

In light of these challenges, it is not surprising that the early years of existence are tremendously volatile for new firms. In fact, various studies have indicated that 30% of the new firms launched in the United Kingdom were out of business by the third year following formation and the number increased to 50% by the fifth year. Of those firms that are able to survive only a small number grew beyond 20 employees. In order to achieve the desired growth rate, or to simply just survive, new businesses must be able to develop appropriate management skills, attract sufficient capital, and make the right strategic decisions with respect to creation, acquisition and marketing of their products and services.

## **§2:2 Critical success factors**

The risks associated with emerging companies have led to keen interest in attempting to identify the critical success factors that are likely to be relevant in predicting how a particular firm will fare in the marketplace. The term critical success factors in the context of a business organization can be understood as referring to the primary process performance measures that most closely define and track how the organization must

perform in order to be considered successful. In order to be effective and meaningful the critical success factors for a company must be directly related to the business and strategic objectives and goals of the company as set out in a formal business plan and must also be defined in a way that they can be easily monitored by senior management to quickly determine whether the company is “on track.” One common analogy used with respect to setting and reviewing performance against key indicators is the instruments commonly found on the dashboard of an automobile or an airplane.

It is admittedly difficult to measure performance, and establish critical success factors, in the early days of a new venture that has been launched based on an emerging technology that will hopefully create markets that do not currently exist. At that point the various entrepreneurs (i.e., the founders and other senior managers) lack the traditional points of reference typically used to design critical success factors—there are no products on the market, the market itself is still to be evaluated and defined, competition has yet to emerge, standards are lacking, and decisions have yet to be made regarding the involvement of regulators and the boundaries of property rights that may be associated with new technologies. What often occurs is that a list of milestones or benchmarks is created to serve as a roadmap of the path of events that need to be completed in order to achieve “success”: close the first round of venture capital funding, complete development and testing of the initial product, establish of one or more key strategic alliances, successfully launch the initial product, rollout additional products, and complete a successful initial public offering. A target date is assigned to each milestone and a detailed list of the activities that need to be undertaken to reach each milestone is also created.

Certainly each of the events listed above is important; however, they are more correctly viewed as the desirable consequences of having identifying and managing critical success factors rather than being success factors in and of themselves. For example, it is more accurate to identify what the company should be doing in order to obtain financial resources from venture capitalists or complete and launch its first product efficiently and on a timely basis. These “factors for success,” which should be the subject of measurement as indicators of performance, might include establishment of an organizational structure and project management capability to support operational activities or creation of a high-quality new product development process. It should also be noted that achieving a certain benchmark may itself improve performance with respect to a critical success factor. A good illustration is the expected improvements in process development that a smaller company can expect from absorbing knowledge from larger and more experienced partners during the course of a strategic alliance relationship.

Not surprisingly, the search to identify critical success factors for fledgling technology-based companies has spread far and wide and there have been numerous studies on the subject. In general, research in the area of critical success factors for emerging companies has focused on the identification and studies of two main groups of factors: “internal” factors, which focus on the characteristics of the particular company and its founders and senior managers which can usually be affected by the company itself; and “contextual” (or external) factors, which focus on the organizational environment in which the company is operating and generally exist independent of the activities of the

company although management generally has some discretion in defining key elements of the organizational environment in which the company will be operating. Each main group can be further broken down into specific categories for closer analysis. For example, internal factors might be classified by reference to human resources, product development strategies, organization structure and culture, and stakeholder relationships. In turn, contextual factors include the creation and operation of regional clusters of firms working on related issues, the breadth and condition of the infrastructure supporting the activities of the company (e.g., transportation, telecommunications, availability of affordable housing, etc.), and governmental policies relating to the technologies and markets of interest to the company. There will obviously be some overlap between internal and contextual factors such as whether the local housing market is attractive enough to support the company's efforts to recruit the personnel deemed critically necessary for success.

### **§2:3 --Internal factors**

The success or failure of a new business venture will ultimately depend, to some extent, on the skills, energy and judgment of the founders and the other members of the senior management team. These factors, including the personal characteristics and experience of the members of the founder-manager team and the specific strategies that they select to cope with their company's business environment, are typically classified as "internal," since they are integral part of the firm itself and the way it is managed. Outside investors who place the greatest emphasis on internal factors are said to fall into the camp of basing their bets on the "jockey" (i.e., the management team) rather than on the "horse" (i.e., the business model). For example, Arthur Rock, a revered investor who was one of the first to see the promise in Apple Computers, has often been cited for this belief that the quality, integrity and commitment of the members of the management team is the most important factor in an investment decision. Others have taken a similar view by favorably quoting the following saying: "You can have a good idea and poor management and lose every time. You can have a poor idea and good management and win every time."<sup>1</sup> However, other studies have shown that once a firm emerges from the very earliest stages of development the company's ultimate success is determined by non-human factors such as intellectual property rights, customer relationships and physical assets and firms with the right product in the right market will thrive even if there is substantial change within the management team.

Not surprisingly, various studies have focused on certain personal characteristics of the founders and other managers of a company in an effort to predict whether the company would be able to achieve rapid growth. For example, Barkham et al argued that there is a significant positive correlation between faster growth and characteristics such as the relative youth of the ownership group; shared ownership and cooperation, meaning that more than one person had an equity stake in the business and that there was a willingness to work together as a group; serial entrepreneurship among the founder-manager group, meaning that members of the group have been involved in more than one business activity; and membership in professional organizations, which generally meant that the

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<sup>1</sup> D. Gladstone, *Venture Capital Handbook* (Financial Times Prentice Hall, 2002), 91-92.

founders and managers had achieved recognized levels of technical competence and certification (e.g., engineering).<sup>2</sup> Storey evaluated empirical studies of founder-manager teams conducted by a number of other researchers and concluded that the most commonly-cited predictors of rapid growth for companies led by those teams included relatively high levels of education and extensive management experience from previous positions. Storey also noted that the companies that were most likely to be successful in achieving high growth were led by a team or group of entrepreneurs, rather than just one individual, and that the leadership team was usually middle-aged, a finding that was somewhat at variance with Barkham et al but consistent with advanced education and management experience.<sup>3</sup>

In contrast, advocates of the strategic management theory posit that the most important internal factors are not the personal characteristics of the founders and other members of the management team but the actual choices made by those persons with respect to charting the course for the business in light of the relevant environmental conditions. This approach is consistent with the belief that entrepreneurship is not simply discovering a “bright idea” but rather is the entire continuous process of collecting and organizing the necessary resources, identifying the best opportunities for quickly executing the idea and then organizing the resources in a way that is best suited to take advantage of those opportunities. Studies focusing on the relationship between strategy and success for companies targeting rapid expansion have identified the following factors as being extremely important to predicting how well the business will operate: the specific functional strategies and skills of the company, particularly in areas of marketing and production; the level of technology usage and expertise; and the quality of the infrastructure created by the firm to penetrate and exploit new markets. Harrison and Taylor, in their study of “super growth” companies, identified the following key “winning performance factors”: competing on quality rather than pricing; domination of a market niche; competing based on areas of strength; implementation of tight financial and operating controls; and frequent product or service innovation.<sup>4</sup> Levie made a similar finding in a survey that demonstrated that sustained growth was more likely to occur when a firm elected to follow a narrow market entry strategy in a rapidly growing market or industry as opposed to attempting broader strategies in markets or industries that had matured.<sup>5</sup> Other research in this area highlights the importance and positive impact of production focus and exceptional customer service.<sup>6</sup>

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<sup>2</sup> R. Barkham, G. Gudgin, M. Hart and E. Hanvey, *The Determinants of Small Firm Growth: An Inter-Regional Study in the United Kingdom 1986-90*, Regional Policy and Development Series 12 (London: Jessica Kingsley Publishers and Regional Studies Association, 1996), 37.

<sup>3</sup> D. Storey, *Understanding the Small Business Sector* (London: Routledge, 1994), 157.

<sup>4</sup> J. Harrison and B. Taylor, *Super Growth Companies: Entrepreneurs in Action* (Oxford: Butterworth-Heinemann, 1996).

<sup>5</sup> J. Levie, “Strategies for New Venture Growth and Harvest: A Five Year Follow-Up of 176 Young Growing Firms in Denmark, Ireland and Scotland”, *Frontiers of Entrepreneurship Research* (Wellesley, MA: Babson College, 1995).

<sup>6</sup> J. Baum, “On the Relation of Traits, Competencies, Motivation, Strategy and Structure to Venture Growth”, *Frontiers of Entrepreneurship Research* (Wellesley, MA: Babson College, 1995).

Another approach to evaluating how strategic decisions relate to the success of a firm is illustrated by research conducted by Accenture on how “business success” should be defined.<sup>7</sup> The researchers began by looking at the following five key quantitative and qualitative dimensions of business performance of larger firms over a seven-year period, all of which were also compared against a carefully selected set of competitors: growth, as measured by expansion of revenues over the measurement period; profitability, as measured by the difference between the company's return on capital and its cost of capital; positioning for the future, as represented by what the researchers refer to as “future value”--the portion of the company's share price that cannot be explained by its current earnings--and by the portion of the industry total that each company's future value represents; longevity, as measured by the duration of out-performance in total return to shareholders; and consistency, as measured by the number of years during the measurement period that the company exceeded the median level of profitability, growth and positioning for the future within its group of competitors.

The researchers acknowledged that the relative importance of the five high performance measures might vary from industry-to-industry and that care should be taken before attempting to make comparisons between firms that are not part of the same peer group of competitors. Nonetheless, they felt it was also possible to identify the following three drivers of performance, or “competitive essence,” that were applicable to firms across industry boundaries:

- Market focus and position, which means knowing “where and how to compete” and successfully scaling the business by adroitly exiting mature markets and consistently identifying new markets and entering them on a timely basis;
- Distinctive capabilities, which includes the unique set of business processes and resources that cost-effectively serve the specific needs of customers (referred to by the researchers as “differentiation on the outside and simplification on the inside”); and
- Performance anatomy, which begins with a set of stable values developed by the leaders of the company and continues with the constant use and communication of those values to create a shared mindset within the company regarding critical organizational elements such as the balance between strategy and execution; the cultivation of talent; the strategic importance of information technology; the need to measure performance selectively; and the drive for continuous innovation and renewal.

Also interesting was the observation that an apparent condition for aspiring to become a high-performance business (although not a guarantee that the level of performance will actually be achieved) is world-class excellence across the whole range of key functional areas and cross-functional activities (e.g., supply chain management; human performance; customer relationship management; finance and performance management; strategy; and information technology).

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<sup>7</sup> T. Breene and P. Nunes, “Going the Distance: How the World's Best Companies Achieve High Performance,” Outlook Journal (September 2006).

As with much of the research in this area, Accenture focused on large companies and thus the applicability of the conclusions to emerging companies is not completely clear but for the fact that emerging companies, almost by definition, aspire to become world leaders at some point in the future. Four concepts do, however, are interesting for founders and senior managers of emerging companies . . . creating “future value,” mastering market focus and position; identifying and cultivating one or more distinctive capabilities; and laying the foundation for a strong performance anatomy. By appreciating the ultimate importance of these activities at an early stage, the leaders of an emerging company can consciously invest their time and company resources in pursuit of the goals that will pay the largest dividends in the future. This means, for example, establishing a solid infrastructure for evaluating market trends and customer needs and fostering a culture that encourages personal development and growth and innovation.

#### **§2:4 --External factors**

Some researchers argue that external, or contextual, factors are the most important when considering the chances of success for a particular entrepreneurial venture or governmental policies that are intended to provide support for new business activities. These factors include such things as governmental support; market and cultural factors in the home country of the firm; industry characteristics, including the stage of development and nature of the customer base; location and market sector; and the competitive structure of the industry and the place of the firm therein as measured by its comparative advantages in relation to current and potential competitors. Bruno and Tyebjee were among the first to create an extensive list of external factors that they found to be important supports for entrepreneurial activity: venture capital availability; presence of experienced entrepreneurs; a technically skilled labor force; accessibility to suppliers; accessibility to customers or new markets; favorable government policies; proximity to universities; availability of land and facilities; accessibility to transportation; a receptive population; availability of supporting professional services; and attractive living conditions.<sup>8</sup> If the importance of external factors is recognized then it follows that a key determinant of the success of a new venture is the ability of the founders and other senior members of the management team to establish the appropriate strategy for handling uncertainty in their external environment and identify and acquiring the necessary resources from that environment.

#### **§2:5 Challenges for managing emerging companies**

Several researchers have carefully studied the progress of firms that appear to have the potential for rapid growth—emerging companies—in an attempt to identify some of the specific challenges that those firms and their managers can expect to encounter and the strategies that are most likely to be successful in overcoming those challenges. Some of the challenges are primarily related to the personal situations of the founders and the other members of the senior management team such as the lack of adequate management time, inadequacies in management skills, and conflicts within the management group. A

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<sup>8</sup> A. Bruno and T. Tyebjee, “The Environment for Entrepreneurship”, in C. Kent, D. Sexton and K. Vesper (Eds.), *Encyclopedia of Entrepreneurship* (Englewood Cliffs, NJ: Prentice Hall, 1982), 288.

shortage of necessary resources, such as qualified labor and/or suitable financing for expansion and credit facilities, was also often problematic. Interestingly, managers of growing firms apparently were relatively unconcerned about competition or lack of demand, both of which are consistently identified as significant challenges by managers of firms suffering through static or declining patterns. However, any new firm must anticipate that it will need to overcome certain barriers to entry and work hard to establish a reputation and track record.<sup>9</sup>

Hendrickson and Psarouthakis<sup>10</sup> identified the following eight issues that they believe must be managed in order for firms to realize growth-oriented objectives:

- **Resource Acquisition:** How does the firm acquire the necessary capital, human resources, assets, and information to launch and operate the business?
- **Resource Allocation:** How does the firm best deploy its accumulated resources?
- **Work Flow:** How are the required work activities of the business to be divided and organized to ensure efficiency and effective communications?
- **Human Relations:** How does the firm motivate and satisfy its human resources and encourage employees to understand and share a common vision?
- **Technical Mastery:** How does the firm achieve and maintain the necessary technical know-how to attain the highest levels of productivity and quality?
- **Market Strategy:** How does the firm identify its market niche and determine who its customers are and what they are looking for in making their purchasing decisions?
- **Public Relations:** What external groups, other than suppliers and customers, are important to the firm's future and what strategies should be adopted for dealing with those groups?
- **Financial Viability:** Can the firm meet its financial obligations as they come due, grow its asset base, and operate profitably?

Achieving each of these objectives requires its own strategy and the day-to-day activities of managers and employees within the company can be understood as essential elements in pursuing each of those strategies. For example, recruitment of new employees is part of the company's resource acquisition strategy and compensation and benefit planning is part of the company's resource allocation strategy. The company's work flow strategy will be impacted and defined by decisions on job design and descriptions. Communications with employees in the form of meetings, manuals, policies and newsletters are an integral part of the company's human relations strategy. Training and development programs are important to several different issues. Training of sales and marketing personnel can advance market strategy, while technical training should improve the company's technical mastery. In addition, training for managers should assist them in motivating employees (i.e., human relations) and smoothing work flow.

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<sup>9</sup> R. Barkham, G. Gudgin, M. Hart and E. Hanvey, *The Determinants of Small Firm Growth: An Inter-Regional Study in the United Kingdom 1986-90*, Regional Policy and Development Series 12 (London: Jessica Kingsley Publishers and Regional Studies Association, 1996).

<sup>10</sup> L. Hendrickson and J. Psarouthakis, *Dynamic Management of Growing Firms: A Strategic Approach* (Second Edition) (Ann Arbor, MI: University of Michigan Press, 1998).

## Embracing Challenges to Create a Compelling Story for Investors

*While in practice it is difficult to draw lines between each of the issues listed above, they do provide a starting point for analyzing the needs of a new business and communicating a story to potential investors. For example, entrepreneurs need to be able to explain to investors what will be needed in terms of capital, human resources, assets and information in order for the business to be successfully launched and operated. While presumably investors are being contacted to address the capital requirements of the business, the money won't be forthcoming unless the investors are satisfied about the entrepreneur's plans for acquiring the right people and technology and are convinced that the entrepreneur has the skills necessary to deploy and manage the human and technological resources so that milestones in the business plan can be achieved on a timely basis. Entrepreneurs often lack the details that investors require with respect to how the money will be spent and have difficulty explaining to investors how they intend to organize work activities, motivate their employees and achieve the level of technical mastery necessary to create high quality products and services. In order to avoid problems, entrepreneurs need to go beyond head count projections and be prepared to show investors how the new company's critical first product development project will be managed. While sophisticated investors will understand that things don't always go as planned, they will be interested in how the entrepreneur approaches and explains the development process and will want to understand the key assumptions that the entrepreneur is making and how they are impacting the timetables and budgets in the new company's business plan.*

### §2:6 Common problems confronting emerging companies during start-up

The period immediately following the initial launch of an emerging company, the so-called “start-up” phase is particularly critical for the ultimate survival of the business and calls for keen management skills and, in many cases, a dose of good fortune. Slatter identified the following as being among the most common problems confronting technology-based companies during the start-up stage: delays in product development; premature market entry; incorrect customer and market identification; lack of credibility with potential customers; unrealistic delivery promises; and lack of control over subcontractors.<sup>11</sup> A comprehensive review of the literature by Kazanjian to assess the relation of dominant problems to stages of growth in technology-based businesses identified the following factors as being particularly important during the start-up phase<sup>12</sup>:

- **Organizational Systems:** This factor included the need to develop financial systems and internal controls, as well as management information systems, and define responsibilities within the firm.

<sup>11</sup> S. Slatter, *Gambling on Growth: How to Manage the Small High-Tech Firm* (Chichester UK: John Wiley & Sons, 1992), 61-68.

<sup>12</sup> R. Kazanjian, “Relation of Dominant Problems to Stages of Growth in Technology-Based New Ventures,” *Academy of Management Journal*, 31, no. 2 (1988), 257-79.



- **Sales/Marketing:** This factor focused on attainment of sales, profit and market share goals, penetration of new geographic markets, and development of product service and support.
- **People:** This factor emphasized the need to recruit capable personnel; however, no reference was made to culture and employee satisfaction and morale issues.
- **Production:** This factor covered the ability of the firm to improve the procurement and production functions to the point where sufficient volume could be generated to meet customer demand.
- **Strategic Positioning:** This factor included development of new product or technology applications and entry into new product market segments.
- **External Relations:** This factor included relationships with capital providers, as well as recruitment of outside professional advisors and board members.

Another way to identify problems is to learn more about why emerging companies failed to realize their potential and achieve the aspirations the founders had in mind when the business was first launched. Mottram acknowledged that emerging companies are, by nature, risky ventures that are highly likely to fail; however, he argued that based on his experience in working with emerging companies the founders frequently engaged in a common set of behaviors that doomed their firms yet could have been avoided or mitigated. In an effort to warn founders of challenges that may ultimately overwhelm them Mottram listed and described “10 Reasons Why Emerging Companies Fail” in a blog post that first appeared in 2009<sup>13</sup>:

- **Myopic or extraneous market research:** The failure of the founders to validate their ideas using basic qualitative and quantitative market research using assumptions that have been developed to avoid any bias which might influence the data and pre-determine the outcome. Faulty research leads to poor business and marketing planning and strategies based on the founder's personal experiences rather than hard data from the actual marketplace itself.
- **Product development guided by internal perceptions and biases:** Founders need to remember that a new technology, regardless of how innovative it might be, is of little use to customers unless it provides them with a cost-effective solution to a real problem they are facing and provides them with a new way to increase their profits and/or become and remain more competitive.
- **Overly optimistic marketing plans:** Founders should certainly develop a marketing plan that creates enthusiasm within their team; however, care should be taken not to become too optimistic and pursue goals that are unrealistic and set the stage for failure and deterioration of morale and scarce resources.
- **Incomplete product:** Founders need to remember that customers evaluate products, particularly technology-based products, on the basis of the entire customer experience and not just a particular feature or function. Accordingly, product development needs to be seen expansively and include installation, training, financing, technical support,

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<sup>13</sup> B. Mottram, “10 Reasons Why Emerging Technology Companies Fail”, Storagetopics (blog), July 27, 2009, <http://www.storagetopics.com/2009/07/why-technology-products-fail.html>, accessed November 6, 2014.

application support, application ecosystem and customer comfort with the company's reputation in the marketplace. The goal should be to build and maintain a brand not just a commodity product or service.

- **Undifferentiated products:** Founders must be sure that their new products can be easily differentiated by prospective customers and that the point of differentiation is considered meaningful by customers and not just the founders and their team members. Following on the point above, founders need to remember that customers look at their entire experience and there are opportunities for differentiation that are outside the familiar issues of features and pricing.
- **Weak or confused market focus:** While founders are eager and anxious to generate sales revenues as quickly as possible care must be taken to avoid weak or confused market focus and marketing efforts should be directed toward niches and segments that offer the best opportunities for success. Many companies fail because they chase any new sales possibility regardless of whether it will be profitable or whether it makes sense in the long-term and the result is that scarce resources are overextended and support costs increase over the original budget.
- **Vague messaging and poor positioning:** Founders need to avoid getting caught up in their own excitement and take the time to sit down and calmly and objectively develop a clear statement and argument for customers regarding the value of the new product or service as a solution for customer problems and position the product or service in a way that allows customers to easily differentiate it in a noisy and competitive marketplace.
- **Channel confusion:** Once again, in their pursuit of quick sales founders often neglect to take the time to develop a coherent channel strategy. The founders need to take the time to make the tough choices among direct, indirect and combination sales strategies and then closely manage each of the channels to avoid conflicts and ensure that each channel is being pursued effectively.
- **Executive thinking that promotion is marketing:** Founders and other senior executives of emerging companies often believe that marketing has only one goal: generating demand for the company's products and services. While demand generation is important, emerging companies cannot ignore the need to build the company's reputation and brand, both of which are essential to the long-term success and sustainability of the firm.
- **Marketing and sales teams disconnected:** Founders need to act carefully and thoughtfully as they distinguish and build out the marketing and sales teams and make sure that there is communication and coordination between the functions in key areas such as identifying segmentation and target customers, development and implementation of "go-to-market" strategies, channel strategies, lead generation and qualification, sales tools and training.

Several years later in 2014, Mottram restated his original list and added a few more potential problems outside of his original focus on marketing and sales issues including the following: lack of passion and persistence among company leadership; dysfunction, including conflicting agendas, among the leadership team; operational mediocrity and inefficiencies; inability to think and act fast: being too dogmatic and thus unable or unwilling to react to market changes; lack of mentors or advisors; insufficient funding;

unprofitable or no business model; over-expansion; poor launch strategy and lack of coherence within the launch team; and an idea that is not scalable.<sup>14</sup> While Mottram's catalog is extensive, founders must be mindful of the need to overcome other challenges such as poor cash management skills, failure to create a well-developed business plan, poor pricing strategies, unwillingness or inability to recognize areas in which they need help from others, failure to delegate, poor hiring decisions (i.e., hiring people that think the same way as the founder as opposed to people with different viewpoints and complementary skills and experience), failure to understand and pay attention to the competition and too much reliance on a single customer.

### **§2:7 Milestones for change and transition within emerging companies**

There have been a number of attempts to identify the stages of development of a business and recognizing and accepting that change and evolution is inevitable is essential to the pursuit of continuous success and survival for the enterprise. There is no universally accepted growth model for emerging companies; however, it is clear that as time goes by there will be changes in immediate business objectives, predominant management style, organizational structure, the state of the company company's product and market activities and the most pressing managerial challenges (e.g., resource management, sales and marketing, and communications and cooperation within the organization). For example, Hendrickson and Psarouthakis have provided a useful and comprehensive list of some the milestones that tend to trigger the need for change within firms that are experienced rapid growth:

- As the firm grows, resource acquisition priorities shift from capital to recruiting qualified and experienced managerial and technical employees.
- In the marketing area, growing companies may find that they can no longer fulfill their appetite for expansion in a small niche that allowed the company to launch successfully. As a result, the firm must adopt more formal strategic planning methods to locate and attack new markets and/or develop new products or services.
- As the business grows and becomes more complex, senior managers must be more mindful of outside constituencies and requirements, particularly laws and regulations that come into play as the firm increases in size and the number of customers and other business partners expands.
- As the customer base expands and orders rise, the company must learn to carefully manage its available resources. The simple and basic internal controls that were adequate when the firm had only a handful of customers must be replaced by formal budgets and computerized accounting.
- The need for the firm to expand into new markets and service more customers tends to lead to more specialization among managers and employees. This not only impacts the way in which the company must recruit and select new employees, it also creates challenges of communication to make sure that tasks and activities do not overlap.

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<sup>14</sup> B. Mottram, "Revisiting a popular post: '10 Reasons Why Technology Companies Fail'", Storagetopics (blog), July 11, 2014, <http://www.storagetopics.com/2014/07/why-companies-fail.html>, accessed November 6, 2014.

- Employee growth and increased specialization inevitably lead to great distance between the founders and professional senior executives, such as the CEO, and other parts of the organization. As a result, it becomes most difficult for the CEO to keep an eye on the pulse of the firm and directly and clearly convey his or her sense of company mission to employees.
- The need for advanced internal controls, standardized products, and enhanced product quality and productivity means that the firm must focus on improving technical mastery through recruitment of new employees and ongoing training of current workers.

Of course, the CEO of every firm, regardless of its goals and expectations with respect to growth, may need to initiate changes that are unrelated to the challenges described above. For example, change may be triggered by recognition that a current strategy or approach is no longer effective or that it is no longer sufficient to attempt to operate without formally addressing a particular issue; the need to seize an opportunity to make improvements in the way that the firm may already be dealing with a particular issue, such as increasing efficiencies and further reducing costs; or the need to respond to major changes in structure or other internal circumstances, such as a significant change in the number of employees, diversification, acquisitions, or the departure of one of more key senior managers.

Responding to these challenges requires specific actions by the founders and other members of the senior management team of an emerging company including development of the proper strategies for recruiting employees with proper technical skills and experience; proper design and implementation of corporate budgeting and planning systems; establishment of an efficient purchasing and production systems to ensure that products can be manufactured in a timely manner and at desired levels of quality; development of strategies for creating a loyal and satisfied group of employees, including training and skill development programs to build and maintain technical mastery; and proper investment of time and other resources in market research and new product development to create products and services that address an identifiable customer demand. While the solutions can often be readily identified actual execution may be hampered by resistance to change, shortcomings in diagnosing the causes of the particular problem or issue, inappropriate solutions and failure to adequately measure and evaluate the results of the change in relation to the situation that existed in the past.<sup>15</sup>

Other surveys and research efforts over the years have provided additional insights and perspective on challenges confronting emerging companies. For example, a study of a group of Inc. 100 companies in the early 1980s identified the following crucial transformation issues that must be overcome in order for firms to be successful in their growth plans: acquisition of management resources, both at the executive level and at middle management, development of work flow systems, human relations and cultivation

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<sup>15</sup> L. Hendrickson and J. Psarouthakis, *Dynamic Management of Growing Firms: A Strategic Approach* (Second Edition) (Ann Arbor, MI: University of Michigan Press, 1998).

of firm culture, and resource allocation.<sup>16</sup> In addition, interviews of CEOs of 121 Inc. 500 companies conducted in the early 1990's identified the following as key problems that arise as the firm moves beyond the start-up stage and into the period where rapid growth is anticipated: obtaining adequate capital, raw materials and human resources; controlling margins, expenses and cash flow and developing sufficient production capacity; modifying allocation of job responsibilities, transitioning from customized to standardized products, and training and development of workers; building employee satisfaction and morale and reducing turnover; developing technical expertise and integrating it into product development and production processes; and building a broader customer base and developing new marketing and distribution channels.<sup>17</sup> The researchers also identified lack of management time and expertise as an important issue that tended to contribute to the challenges in each of the areas listed above.

### **§2:8 Strategic alternatives for emerging companies**

While an extensive discussion of strategic alternatives for emerging companies is beyond the scope of this chapter it is useful to understand the different categories of strategies that have been identified for these types of companies. New companies may select from among a number of identifiable strategies when identifying their initial activities. Each activity has its own level of risk and resource requirements and the appropriate mix of activities will depend on a variety of factors. For example, relatively low risk activities that may be completed with a limited set of resources include technology consulting, contract research work, and development of custom and semi-custom niche products. Pursuit of these activities may be appropriate in cases where the ultimate market for the company's products and technology is still emerging and final direction is difficult to predict. On the other hand, development of standardized products for potentially large markets is a much higher risk activity that will require substantially more resources, including capital to allow the firm to survive until the development is completed and the product is launched. A strategy based on these activities should be considered when the firm is confident about the technology and the size of the market. In some cases, the firm has little choice but to proceed in this direction if the company's internal technology base is so narrow that it is impractical to try and take on a diverse set of consulting and niche development projects.

Assuming that the business concept underlying the new firm is based on commercialization of a "radical" technological innovation the first step will normally be adaptation of the technology to an identified need in the marketplace and educating potential customers about the technology and the ways in which it can be used to solve a specific problem of importance to the customer base. The activities of the firm at this stage have been characterized as "research and consultancy" and the company will often engage focused contract activities to diffuse knowledge about the commercial applications of the technology, as opposed to ramping up for large-scale production of

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<sup>16</sup> D. Hambrick and L. Crozier, "Stumblers and Stars in the Management of Rapid Growth," *Journal of Business Venturing*, 1 (1985), 31-45.

<sup>17</sup> D. Terpstra and P. Olson, "Entrepreneurial Start-up and Growth: A Classification of Problems," *Entrepreneurship Theory and Practice*, 17, no. 3 (1993), 5-20.

standardized products. In many ways, the firm and its products are still “soft” at this stage and changes may be made as a result of information gained during the consultation activities. The next stages of development may include distribution of the company’s proprietary products by other companies and eventually creation of the company’s own independent functions for manufacturing and marketing.

One strategy used by emerging companies is referred to as “focused” and contemplates that the firm will attempt to secure a dominant position in a specific market niche. A more “broad-based” strategy emphasizes introduction of the technology into a wide range of products and industries, often through joint ventures and other strategic alliance with third parties. Some companies opt for an “early product” strategy based on rapid introduction of new products into markets with low barriers to entry and relatively small consultancy costs. This strategy is generally followed when the firm is looking to generate cash quickly in order to continue to finance development of more sophisticated products that can be launched using one of the other strategies. If, for whatever reason, the firm is destined to pursue the riskier path of developing a full-fledged line of standardized products, consideration should be given to various strategies that can be used to manage those risks and keep the company moving forward until a return on the large investment can be realized. Among the possibilities are the following:

- Companies may gain experience with some of the activities related to development and commercialization of their selected products by providing manufacturing, distribution or service for similar products designed by other manufacturers. These projects not only build the knowledge base of the firm, but also can provide cash flow that can be used to continue the product development effort and begin building the necessary support functions.
- Complementing the standardized products with additional offerings of customized versions that are built to meet the specific requirements of various market segments within the broader product class.
- Entering into large contracts with one or more customers to provide a specified volume of products. These types of contracts with key customers, particularly customers that are perceived as important players in the target market, can provide a steady stream of revenues and also create opportunities for the firm to improve its manufacturing and service functions. The downside is that these large contracts may derail the firm from pursuing its primary product development objectives. Moreover, in some cases, restrictions in such contracts make it difficult for the firm to expand its customer network.
- Entering into “private label” or OEM contracts can provide benefits similar to those associated with large customer contracts, notably cash flow.

The success of the selected strategy will depend, to some degree, on the reaction from established competitors. A variety of scenarios are possible, including attempts to improve existing technologies to reduce the innovative appeal of the products offered by the start-up firm or an effort by incumbents to secure technological leadership by either creating similar products at lower prices or moving forward with development of second generation products. Efforts to attain technological leadership are generally facilitated by

the fact that incumbent firms are typically larger and already have an integrated functional structure that includes development, manufacturing and distribution. Start-up firms confronted by this type of opposition face greater challenges in surviving long enough to become an independent and fully functioning entity and are often forced into acquisition, termination or continuation as a small niche player supporting the larger firms. A well-known example of this type of reaction can be found in a review of the early years of the biotechnology revolution. As small firms began to emerge, large incumbents in many industries, including agricultural, chemicals and pharmaceuticals, responded by making large investment in traditional technologies and in biotechnological research itself. It should be noted that the optimal situation for growth is probably somewhere between these two extremes, since small innovative firms will need industry cooperation, in the form of financing and marketing arrangements, to continue to grow.