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What Form of Business?

What Are Our Options?
The Formal Business Plan
Everything has its Price if We Can Price it Right

The Oracle of Delphi which was held to be the center of the ancient world, was the focus of all anxious seekers of truth. We're far from her influence today, but knowing our opportunities, planning for them, and pricing them right may give us the stimulus we need to make our business grow and prosper.

WHAT FORM OF BUSINESS?

WHAT ARE MY OPTIONS?

This is a typical scenario confronting a small business. SmallBiz, Inc., has successfully operated for several years and believes it has a technology edge over its competitors.

Products from the technology have been sold into specific markets, but SmallBiz believes its underlying technology has wider market applications.

Business failure is most often caused by lack of effective planning.

SmallBiz wants to either cash-in or grow its business. It is unsure of what steps to take in deciding whether to sell the company, expand it with outside funding, form alliances, or license the technology to others. The question—how to protect earning potential while maximizing upside income potential and, at the same time, minimize risk?

The answer depends on the combined personal and business goals of the company shareholders and its resources. Always start with the end in mind!

Review the annual business plan (we do have one, right?), which lists the company's mission, core strengths, and resources. Most small business pundits suggest that the major reason for business failure is a combination of lack of capital and poor management. Experience, however, suggests that the single most important cause of business failure is the lack of effective planning. Most often, running out of money is the inevitable result of poor planning, and is certainly the hallmark of poor management.

Management Is An Art. Just as doctors or lawyers must practice their profession, the small business owner must practice the art of management. Most small business owners either inherit their business or have struck out on their own as entrepreneurs, leaving the safety and support of the corporate womb. As entrepreneurs, they are skilled in their own field, craft, or service. As inheritors, there is a tendency toward inbred and stale ideas. Both types of small business owners have one thing in common—they have not been trained as managers and, therefore, have not been trained to plan.

What is planning? Planning is any systematic way of thinking about the business: about its performance and its current and future needs. Planning is what provides the business owner with reliable information to make critical decisions that will maximize the chance of correct decision making. I am a great believer in success through planning.

In large companies, corporate goals, capital, and resources are devoted to protecting market share in major business areas while neglecting opportunities in specialty business units. Safety in numbers is the rationale.

Contrary to popular opinion, the small company does enjoy advantages over the major company. In the small company, planning cannot and should not produce an over abundance of paperwork. The real strength of the small company is its ability to function as a guerrilla unit: to move quickly with strong, personal, and verbal working relationships among its employees. The planning process can be based upon a series of well-prepared meetings including all the key people. Contrast this with the remote process that the major company must use.

Use this strength to get people involved. Hold a series of meetings with employees and include some of their contributions in the final plan. This will ensure that they have a clear understanding of company goals and spur a commitment from them to achieve those goals. If this becomes a lip service exercise, we will lose our employees' respect. We will benefit from the recommendations of the only people in the world (besides our families) who have a major stake in the future success of our business—our employees.

Remember, the process of planning is not the same as a written, formal business plan. Every successful manager is an effective planner. However, not all of them put their actual plan in writing. Many business owners are reluctant to document their thinking. The traditional excuse is a lack of time. The real reasons are that they lack confidence in their abilities, they are afraid that something in writing will limit their ability to change their minds, or they wish to micromanage their staff.

Plans Are Not Locked In Concrete. Drucker, a well-read business author, wrote that the power of a decision is inversely proportional to the amount of money that it takes to change it. Plans must be updated regularly to reflect changing business circumstances. Plans must not be so detailed that they quickly go out of date. Rather, plans should address the critical strategic problems that face the business. Typically, these problems change relatively slowly.

When plans focus on strategic issues, they will determine the success or failure of the business. Scenarios for an effective course of action must be developed to defend the business against competitors, take advantage of growth opportunities, and improve weaknesses. An effective plan becomes a blueprint with which to run the business, including the obtaining of financing. Furthermore, the plan can be used to build confidence in key customers and suppliers and to hire talented people.

Writing our first business plan can be an intimidating experience. We may need some outside help. Small businesses often need to set up a planning team to provide good advice on a regular basis. Several sources of sound outside advice are available. The first place to start is with our lawyer, CPA, and banker. By drawing on their varied backgrounds, we will have several alternative perspectives to consider. The second source of good advice is from a working board of directors. Find trusted individuals who have successful management careers and who have some understanding of the industry. These associates can serve as a source of ideas for planning and as a sounding board for evaluating the plan.

Always talk to customers, distributors, and industry counterparts. They can provide valuable information on the company image, reputation, and problems common to the industry.

We can take a simple step-by-step approach in which we write down the various steps and meeting notes we accumulate as we navigate through our options and prepare our plan. If we subsequently get lost in the corporate woods, our plan will be a welcome guidepost for finding our way back to the corporate way.

The Final Word. Always develop the plan before getting into the game. Why? We can count on being tempted by two fates in the heat of battle, both with potentially dire consequences. When things are going badly, our tendency is to panic and quit the plan. When things are going well, we rush headlong into new opportunities and overextend our resources. Remember the old Aesop fable—the race isn't necessarily to the swiftest or the strongest. We must stay the course even when the going gets rough.

Pursuing a manufacturing or distribution approach requires significantly more money.

What are our options? Are we more comfortable with developing technology or manufacturing, marketing, or selling the products from the technology? This decision will influence whether we grow the company from its base, sell a portion or all of the business, form strategic relationships to add the missing parts to the puzzle, or enter into licensing agreements. Oh yes, it also depends on the golden rule—how much money, or access to it, we have!

Pursuing a manufacturing or distribution approach requires significantly more money than other approaches available through licensing and forming strategic relationships. In strategic relationships, we can often leverage our most prized capital—knowledge.

Entering a market dominated by large competitors without a real technology edge can be risky because of their significant resources and entrenched position. For example, Sprint and MCI continue to battle AT&T for market share in the U.S. telecommunications industry.

The potential of the market niche and its maturity will be scrutinized by any lender or investor. This objective evaluation forces us to answer many questions we might otherwise avoid. While the company may have the assets and cash flow required to attract a capital, the underlying technology (and developing products and markets from it) may be of broader interest. Time spent in confirming market potential is a critical factor in not only attracting capital, but also in preventing our ownership position from being diluted.

Another alternative is to establish alliances to enhance manufacturing, marketing, or R&D capability. For example, a manufacturer may seek a partner to market its products through a larger sales and distribution network, or engage a technical partner to perform joint R&D, to get the technology to market faster. We can use the joint R&D approach in one of our start-up companies to develop specific applications of interest to our partners. In return for an option on limited rights to a specific market, we can receive R&D funding and a significant option fee. With this arrangement, we can develop both the technology and the value of our company and attract a larger manufacturing company in the future. We also can maintain control of the company, its technology, markets, and its products.

At the other end of the spectrum, if we decide to cash out and sell the entire business, our "compensation package" might include an up-front fee, royalties, and a management/consulting contract. Consult a CPA and tax attorneys to ensure a reasonable valuation is established and tax liability is minimized.

In any event, if we have a tiger by the tail, a little objective planning is in order.

THE FORMAL BUSINESS PLAN

Once we've planned, the next step is to produce a formal business plan. The length and sequence in a business plan will vary with the complexity of the business and its corporate objectives. However, certain key elements are always needed. In particular, management must outline a crisp picture of the business, its background, critical success factors, products, and services. The fundamental question of "why" the business will succeed must be explained.

This question is answered by identifying "what" will make the business succeed. The "what" for business is a viable market interested in and qualified to buy what the business has to sell. Knowing what business we are in helps us understand how to sell our product.

Management must also spell out "how" the business will succeed. This requires the management element—who will be responsible for the various business activities and who will produce and market the product or service.

Finally, the plan must address "when" the business will succeed by showing the planned flow of funds into and out of the business over time.

A detailed outline of a formal business plan follows. We have already touched on many of these elements. This outline is quite comprehensive and may include more sections than we need or want to include in our formal plan.

Overview. Summarizes the background of and basic elements that comprise the business.

Introduction. Addresses the purpose of the business, its history, a general description of its products, product benefits, objectives, and critical success factors. The business environment, including the industry, regulatory climate, market, competition, and barriers to achieving objectives, should be described.

The competition and their relevant strengths must be defined.

The introduction should include the business's alternatives and risks and opportunities. The various strengths and weaknesses in operating the business should be explored. Various options should be examined if the company decides not to invest in the existing business. The introduction also should discuss operating the business as usual; growth through expansion; growth through merger, acquisition, etc.; or contraction and selling out.

Description of Products and Services. Outlines each product, pointing out unique features or special aspects, their advantages, strengths, and weaknesses. Any intellectual property such as patents, trademarks, licenses, and royalties should be explained.

Anticipated changes should be included in this section. What products and services are planned? What products and services will be discontinued? What are the respective product life cycles and the industry environment?

The product strategy also should be covered. The most basic question is how the product will be made, followed by the basic make or buy decision. Who will carry out the R&D and engineering functions? The more subtle questions concerning the product's uniqueness or similarity, the market's size, and the quality of the product should be answered.

Marketing. Looks at several subsets: everything from who to sell to, at what price, and in what flavor. Marketing starts with market research, defines our critical success factors, and ends with a strategy that includes a communications plan.

Market Analysis. Examines the respective economic and industry environments, the customer base, the respective market sizes and market shares for each product, and market geography. This section also looks at the segments that comprise the target and total markets, needs of the market, market opportunity trend analysis, new developments in technology, growth trends in the industry, and government regulations.

The competition also must be defined, paying close attention to company size, market share, and competitive products. How do competitive products compare to the company products? How are they promoted?

Critical Success Factors. Determines what factors are important in marketing the products, as well as the concerns of the markets and targeted industry, regulatory problems, and whether the company is a latecomer or trailblazer.

Strategy. Establishes the primary marketing strategy in promotion and advertising, how the market will learn about the products, and how the business will create a demand for the products or services.

Sales Tactics. Addresses how the products are to be sold (directly or through manufacturer's representatives, agents, and/or distributors) and how sales requests will be handled.

Pricing. Determines the selling price for the product. Small business people tend to undervalue their products or services in the mistaken belief that they are developing market share. It is fundamental to any business that no product should be sold at a profit level that does not cover operating, overhead, marketing, and distribution costs. (The gross margin should be 80 percent or more for a new product.)

Promotion. Spells out how to spread the word on the company and its products. General advertising and sales literature should be balanced with targeted direct mail and sales calls. Suitable point-of-sale displays and incentive programs should be designed for customers and sales staff.

Packaging. Describes the physical packaging, which should be economic and functional while displaying the product to its best advantage. Beauty is in the eye of the buyer and the package often a statement of the corporate philosophy. Color and layouts should be tasteful yet eye-catching for consumers; lower key for industrial products.

Management Plan. Focuses on three subsets: the management team, human resources people and programs, and facilities and equipment.

Management Team. Identifies the key positions in a basic organization chart. Flesh out the skeleton with descriptions of key management personnel who are already onboard and their specific responsibilities. Better yet, define those key people who have to come onboard to ensure the success of the business. This section also should address compensation for the people (salary, bonuses, and incentives), who will serve on the board of directors, and who will provide the professional services not fulfilled by company staff.

Human Resources. Addresses how many people are needed, who recruits new hires, who selects new hires, and what skill levels are needed for the job. The company should also decide whether to hire or buy consulting help to design training programs to keep key people up-to-date and able to manage the business.

Facilities and Equipment. Covers where the plant, offices, and warehouses are located, the capacity/throughput of the plant and equipment, plant utilization rate, and strategy and plans to expand/contract to meet manufacturing needs. The company also should consider whether to lease or buy new equipment, when and how often to inspect and maintain that equipment, and whether to have a vendor quality assurance inspection plan.

Financial Plan. Presents the bottom line. This section should be written with two perspectives in mind. First, imagine presenting the plan to creditors and to bankers and investors for a loan. Second, write down realistic projections. Do not present a false sense of security.

Financial Situation. Reviews and highlights previous financial history and then moves into the current financial condition (history can and does repeat itself in the numbers). This section should document existing credit arrangements and sources by amount and rating. (Consider whether they will come through in a pinch in case of trouble.)

Unit sales, sales, and revenue projections overall and by product should be listed. A comparative industry ratio analysis to compare the company with similar size companies operating in the market should be run. Remember, a banker will use the same ratio analysis to assess debit risk.

A detailed (quarterly) statement of operating, general, and overhead costs—don't forget contingent liabilities, insurance, and tax considerations—should follow. All costs should be expressed on an annualized percentage basis against total costs and revenue projections. This will help identify and target major cost areas to be reviewed and controlled.

Financing Requirements. Projects capital and cash flow requirements. If the company determines a shortfall, it should immediately make an appointment with its banker or lender to make appropriate provisions while the natives are still friendly. The company should think through (and state) its position on giving up equity to secure, or in exchange for, debt. The financial plan will be the basis for the company's financing proposal to lenders.

Appendices. Provide supporting information without cluttering up the plan. Appendices include schedules of major events, personnel resources and key resumes, facilities and equipment data, financial history, product or service cost analyses, revenue forecasts and income, cash and balance sheet projections and financial ratios, organization charts, lists of major customers and principal suppliers, and insurance coverage.

Not all plans will be this comprehensive. This is a detailed and formal corporate plan and, while our plan may not require all of these elements, we should be aware enough of them to recognize whether they are important to our business and our future. Remember the old management adage of not running into buildings. Even if we cannot leap them, we should at least be able to recognize them and do some sidestepping.

Everything has its Price—If We Can Price it Right

Ultimately, our plan boils down to revenues and gross margins as indices of profitability. These depend on how we price our products.

> Price is an element of the product image in the marketing mix.

What is price? A measure of quality? The father of revenues and the stepchild of profits? An element of the product image in the marketing mix? Price is all of these things and much more to the small business. More basically, pricing impacts cash flow, the life blood of small business.

The most common methods of determining price are perhaps the poorest choices. Typically, follow-the-leader and cost-plus approaches are used. Follow-the-leader pricing presumes that our competitors know what they are doing and that their businesses are indeed healthy and their behavior rational.

Cost-plus is the practice of figuring the cost of producing the product or providing the service, and then adding some percentage return. This method may be useful in determining the minimum price for staying in business.

However, both of these methods fail to consider the obvious. What is the customer willing to pay for the product? All consumers tend to equate price with quality and will not pay a price greater than the perceived value received.

Achieving a premium price requires designing the product or service to satisfy the greater needs of the higher-value customer. Go the extra step and do more for these customers than is offered by their present suppliers. Decide how to reach these particular customers to the exclusion of the lower-value customers in the market—this is called niche marketing. Initially, this strategy may appear to be contrary to our longer-term desired result of dominating a broad market sector. This may mean that we follow a "loss-leader" strategy to get our product to market by serving lower-value customers even though these customers probably cannot be served profitably at the beginning of the enterprise. Rifle shot marketing efforts to maximize selling opportunities.

We do not have to be economists to set an initial offering price. The logical steps are fairly simple: determine the break-even price; select the target market; determine an image for the product to satisfy that market; attach a price that is compatible with the desired image; and finally, test the price in the marketplace.

Psychologically, pricing strategy must be influenced by the nature of the product and the timing of its introduction. Here's a brief guide to help us decide if we can charge a "skim" (higher) price when introducing a new product: our product is new or unique; our service is difficult to copy; we have a monopoly, an exclusive patent, or franchise; or we have a status product.

How much will our customers pay for premium-grade products? If we rate the quality of a product as economy, commodity, good, better, or best, the difference in pricing between best quality and economy grade is typically about 9 percent.

When should we charge the same as our competitors? Pricing to match the competition converts the product into a commodity, which mirrors everyone else's. In the process, we forego any differentiation in features or benefits. Here is a guide in determining when to match the competition: we are already the low-cost supplier and can capture market share on other features/benefits; our product is easy to copy; our market is an oligopoly, a fancy name to explain a market with very few sellers; or we have many competitors in our market.

If we must introduce our product or service at a lower price than our competitors', then we need to establish a promotion price and clearly label it as such. Otherwise, our first price will set the market, our penetration pricing strategy may backfire, and our product will lose its value. We may never be able to increase our price in the future.

Adopting a price-penetration strategy to gain market share at a lower price than the perceived customer value is typical of the following situations: our market is price-sensitive; our market is growing in any event; we wish to serve a strong after-market; our cost significantly decreases with volume; or we are the low-cost supplier and wish to discourage competition.

Targeting gross margins or a return-on-sales criteria as our marketing strategy requires that the value to our customer be more than the price we arbitrarily determine by some formula. These strategies work under the following conditions: our market can support volume increases at any price; we are the market leader; we are the low-cost supplier; or we are selling in an inflated environment.

Price can be used to position our product when pricing creates an image of exclusivity. Cosmetics or personal-care products may be priced higher and achieve higher volume when the price says "treat yourself to the very best" or "you are worth it." This strategy works best when the following is true: our costs do not decrease with volume; we are the highest cost supplier; or we want to encourage competition.

Proper pricing should increase working capital.

The best method to determine optimum price is through testing. A simple means is direct mail. Prepare test ads for the product that are identical in every detail except one—the price. Let's say we can't decide whether to charge $3, $4, or $5. We divide our prospect list into three and send out three offers at $3, $4, and $5. The only difference among the offers is the price, and they are all sent at the same time. Timing can strongly impact responses. Also, we make sure that we distribute our offers equally if there's an economic differential in the test areas.

When the orders come in, tabulate the results. We will probably want to go with the price that produces the greatest dollar volume. However, if the difference is less than 5 percent, we should go with the lower offer. Be sure the sample is large enough.

The payoff for proper pricing and serving the high-value customer first should be to increase working capital while saving precious equity. This should reduce the amount of financing needed for the new product at the outset and make the stock worth much more in the future.