S9.1 Entrepreneurship

Introduction

The economy is constantly changing, and entrepreneurs are enterprise creators and agents of change. Entrepreneurs are important in our economy and society, they can change the way we live and work. If successful, their revolutions may improve our standard of living, create social change and contribute to economic growth when new products enter the market and new services are offered.

Entrepreneurship research and theories are important to the advancement of the entrepreneurship field. In the following sections, we will discuss the different types of entrepreneurship and key theories of entrepreneurship.

S9.1.1 Entrepreneurship

Entrepreneurship can be defined as a discipline that seeks to understand how opportunities are discovered, created, and exploited, by whom, and with what consequences. An entrepreneur is an individual or a group who creates a new product, institution, market and/or set of possibilities.

- **Traditional entrepreneurship** focuses on earning rewards by managing projects and accepting and managing the associated uncertainty. They create ventures which aim to maximize profit.
- **Social entrepreneurship** focuses on finding innovative solutions to social and environmental problems. They create ventures which aim to solve social problems and create social change.

While both traditional and social entrepreneurship involves taking charge of some projects that will deliver valuable benefits and bring it to completion to the market, the main difference lies in its main purpose and how they measure performance. Traditional entrepreneurs measure performance by financial measures (profits), while social entrepreneurs measure performance by promoting and enhancing environmental and social change.

S9.1.2 Entrepreneurship Theories

A theory is “a set of interrelated constructs (concepts), definitions, and propositions that present a systematic view of phenomena specifying relations among variables, with the purpose of explaining and predicting the phenomena" (Kerlinger, 1986, p.9). In this unit, we will look at theories that explain entrepreneurship behavior.

Even though it can be argued that theories may be incomplete, poorly developed, based on limited information, and biased to fit our needs — we still use them to guide behavior. Theories are important because they enable us to see things from new angles and perspectives, understand more fully the relationship between entrepreneurship and innovation, and make informed decisions about allocative efficiency.

There are many theories that explain entrepreneurship behavior, but all of them fall into five main fields of study: economic, psychological, sociological, anthropological and opportunity-based. The following sections outline some of the theories on entrepreneurship.

9.1.2.1 Schumpeter Theory

Joseph Schumpeter, one of the most influential economists of the 20th century argued that creativity or innovation is the key factor in any entrepreneur's field of specialization. Schumpeter (1949) holds an entrepreneur (economic and social leader) as one having the major characteristics innovation, foresight and creativity — entrepreneurship as innovation and not imitation. Schumpeter argued that the main goal of an innovator is to serve society and not just to make a profit.

Schumpeter also developed two theories:

1) Mark I theory explains that innovations and technological change of a nation come from entrepreneurs,
2) Mark II theory explains that innovators and the economy are large companies which have the resources to invest in research and development of new products and services at lower prices and therefore the raising of living standards.

According to the Schumpeterian theory, the entrepreneur disrupts the economy out of equilibrium. Marz (1991) highlighted that Schumpeter barely denied that the process of accumulation facilitates social power and prestige. Meaning that the main motive of the entrepreneur is the joy they get from the innovation and the acquisition of social power. This implies that only the business owners that innovate and as a result disrupt the economy out of equilibrium are entrepreneurs and main contributors to economic development.

9.1.2.2 Uncertainty-bearing Theory

The uncertainty-bearing theory was developed by Frank Hyneman Knight in the 1920s to explain the phenomenon of entrepreneurship. According to Knight (1921), the main objective of the entrepreneur is to identify uncertainty, thereby shielding all other stakeholders against the entrepreneur—i.e., the entrepreneur analyses uncertainty in the economy, and takes the best cause of action, hence functions as an insurance agent.

> *The true uncertainty in organized life is the uncertainty in an estimate of human capacity, which is always a capacity to meet uncertainty.* Frank Knight (1921, p. 309)

Knight identified that it is important to make a distinction between risk and uncertainty. He argued that the presence of economic profit signaled the presence of uncertainty; therefore, profit is the entrepreneur's payment for bearing this type of risk.

Knight highlighted that if an entrepreneur's goal is to earn above normal profit, they need to:

(1) Develop useful processes or innovations;
(2) Adapt to the economic environment; and
(3) Accept the consequences of uncertainty.

9.1.2.3 Kirzner's "Alert" Entrepreneur

Kirzner's (1997) theory of the market process helps explain how economies tend to move toward equilibrium, and how entrepreneurialism helps serve that function. Kirzner highlighted that the economy is in a constant state of disequilibrium due to shocks constantly striking the economy and a disequilibrium can only be corrected (to equilibrium) by alert entrepreneurs who identify the opportunity to produce and exchange (goods and services), but the emphasis is on the exchange of opportunities and progress coming mainly from this part. Based on Kirzner's assumption, entrepreneurial progress depends on many players in the business arena, rather than merely a great man.

9.1.2.4 Biological Theory of Entrepreneurship

According to Versheul (2005), there is evidence of gender differences in entrepreneurship both at the micro and macro level. Versheul's research found that female and male entrepreneurs differ significantly with respect to a range of aspects, including self-perception, time investments, start-up capital and HRM, and that most of these differences can be attributed to indirect effects, while some evidence has been found for direct gender effects.

9.1.2.5 Marshall’s Theory of Entrepreneurship

Marshall’s (1949) theory of entrepreneurship holds land, labor, capital, and organizations as the four factors of production, and considered entrepreneurship as the driving factor that brings these four factors together. Marshall’s theory claimed entrepreneurs need to have knowledge and foresight of the industry, economic environment and have good leadership skills, including the courage to act in a risky environment.

9.1.2.6 Other Entrepreneurship Theories

Schultz Approach (1975)

Schultz (1975) argues that entrepreneurship exists in all aspects of life, as we all make decisions regarding our limited resources, for example a student must decide between leisure and study time if they want to get high grades. In business, this theory suggests that a successful entrepreneur has the identify situations of disequilibrium and act sub-optimally by coordinating their resources efficiently to achieve higher levels of satisfaction.

Cantillon's theory (1755)

Richard Cantillon was the first of the major economic thinkers to define entrepreneurship as an agent who buys (labor and capital) means of production at certain prices to combine them into a new product. According to Cantillon’s theory, an entrepreneur is an agent that identifies disequilibrium and takes on the risk and uncertainty to satisfy supply and demand in the market.

Sociological Theories of Entrepreneurship

The studies in the sociology of entrepreneurship analyze the social context, process, and effects of entrepreneurial activity, which matter the relationship between group characteristics and development of business activity. Research in the sociology of entrepreneurship tends to differ from related work in economic theories, as sociology theories on entrepreneurship do not follow simple patterns.

Ruef and Lounsbury (2007) examined the theoretical presuppositions of the field and placed special emphasis on the contribution of Max Weber (2003), whose study provided a useful approach to understanding the context, process, and effects of the entrepreneurial activity.

Ruef (2001) highlighted that business ventures begin by forming teams and that there are three key principles essential for team formation: 1) choice based on homophily, 2) purposive choice, and 3) choice constrained by context or opportunity structure. Forming teams is important for entrepreneurs, another study conducted by Gartner, Shaver, Carter and Reynolds (2004) explained the concept of homophily, which refers to the tendency of people to associate with others like themselves, such as choosing others based on gender or ethnicity. This theory indicates that "ventures could be based on people's tendencies to choose others mastering valuable skills, such as education or experience" (Gartner et al., 2004. p, 303). This means that entrepreneurs will work with individuals that they have something in common with (Ruef 2002). In terms of entrepreneurship capacity to innovate entrepreneurs "need to have the ability to obtain non-redundant information from their social networks" (Ruef 2002, p.427)

Jean-Baptiste Say's Law

The French economist Jean-Baptiste Say is best known for Say's Law of Markets, which states that the production of goods creates its own demand. In his theory, explained:

> *"It is worthwhile to remark that a product is no sooner created than it, from that instant, affords a market for other products to the full extent of its own value." (Say, 1803, p.138–9)*

Say's Law proposes that economic growth is not increasing demand but increasing production. Entrepreneurs produce goods and services with the aim of selling them. This production creates employment and in return workers earn wages and entrepreneurs earn income (profit). In other words, an increase in production results in higher incomes (wealth), which ultimately increases the demand for other goods and service. Say (1803) argued it was irrational for individuals to hoard money because of inflation risk, hence his theory assumes that the market's goal is to clear and that businessmen produce goods that are demanded by the market. During this era, several new innovations, businesses, and inventions were created to satisfy the growing consumer market and demand for technological innovation. Example of innovations includes heavy steel machinery and railroads.

Conclusion

While there are many theories, no view is right or wrong. Every theorist has looked at the entrepreneur and entrepreneurship based on their perception, and therefore, can at best provide a limited view of the entrepreneurial phenomenon. Understanding entrepreneurship theories and research are important to the development of the entrepreneurship discipline, as entrepreneurship is a powerful force for change in the world today.

Reflection Questions

Q1) Discuss entrepreneurship's importance to the economy and society as a whole.
Q2) Compare and contrast the different forms of entrepreneurship in practice today.

Compulsory Reading

- *Neck, H. M., Neck, C. P., & Murray, E. L., (2017). Entrepreneurship: The Practice and Mindset. Sage Publications. (Chapter 1, p. 5-35, Chapter 4, pp.103, 115-116)*
- *Bula, H. O., (2012). Evolution and Theories of Entrepreneurship: A Critical Review on the Kenyan Perspective. International Journal of Business & Commerce. Vol 1(11), 81-96.*
- *Key Terms Table (Appendix 1)*

Additional Readings

- *Cherukara, J., & Manalel, J. (2011). Evolution of Entrepreneurship theories through different schools of thought. EDII 11th Biennial Conference, At Ahmedabad.*

Case Study

- *Social Entrepreneurship – Muhammad Yunus*

S9.2 Entrepreneurship Creativity

Introduction

Creativity is a concept which we often come across in our everyday situations. We hear of creative people, admire creative objects of art or read creative books. Yet despite our almost innate understanding of what it means to be creative, there is much confusion about the nature of creativity. Creativity is defined as the capacity to produce new ideas, insights, inventions, products, or artistic objects that are unique, useful, and of value to others (Neck et al. 2017). Creativity helps individuals, communities, and society alike tackle the new challenges that constantly confront them. The following sections outline several aspects of the theories in creativity.

S9.2.1 Theories in Creativity

Creativity is a process of becoming sensitive to problems, so as to identify problems, formulate hypotheses and test them, construct solutions, and eventually deliver the result (Torrance, 1965). This suggests it is important to be clear about gaps in knowledge and identifying the difficulties with the aim of searching for solutions, including testing and retesting them—and finally communicating the results. Torrance pointed out that:

> *"We have been able to survive with static goals and concepts. Change is occurring so rapidly that we cannot survive if we insist on thinking and living in static terms. We must accept the creative challenge" (Torrance, 1965, p. 679).*

Many researchers have developed models to explain creativity and the creative thinking process. Creative people can utilize resources to develop new ways to tackle problems, implement tasks, and achieve goals and objectives eventually. Entrepreneurs need to understand that creative thinking means looking at something in a new way and the ability to produce original work and ideas — thinking outside the box. The following sections outline some of the research on creativity.

Wertheimer (1945)

Wertheimer (1945) suggested that creative thinking is the process involving breaking down and restructuring our knowledge about something to gain new insights into its nature. An important determinant of our ability to think creatively is the understanding of our own cognitive model of reality. Creativity can enable us to organize our thoughts and bring a different and even better understanding of the subject or situation we are considering.

Maslow's Theory (1943)
Maslow (1943) argued that humans have five basics needs: physiological, safety, social, esteem and self-actualization that must be met for them to thrive and reach maximum potential. Maslow (1954) suggests that creativity as an aspect of human nature and is to be found in all human beings. He classifies creativity as two types, primary creativity and secondary creativity.

- **Primary creativity**
  Maslow suggests primary creativity is the source of new discovery, a real novelty, or ideas which depart from what exists at a given point in time.
- **Secondary creativity**
  Secondary creativity is constructive, synthesizing and integrative part of the inner integration of the person, which is as a characteristic possessed by many scientists when they search for discovery through working collectively, extending the work of previous researchers, and exercising prudence and caution in their claims about new insights or ideas.

Rickards (1985)
Rickards (1985) defines creativity a universal and internal (personal discovery) process, partially unconscious, which leads to new and relevant insights, including discovering new and meaningful perspectives.

Gilliam (1993)
Gilliam (1993) defined creativity as a process of discovering what has not been considered – the act of making new connections. He regards creativity as the creation of useful and valuable concepts in any field. As a result, organizations are eager to find methods for enhancing an individual's ability to generate ideas.

Through the comparison of these various definitions, a common characteristic of creativity among these definitions is that creativity is an ability to conceive new and different viewpoints and develop an in-depth thought of a subject.

S9.2.2 Creativity in Organizations

Logical thinking progresses in a series of steps, each one dependent on the last. This new knowledge is merely an extension of what we know already, rather than being truly new. Over the past few decades, creativity has become a highly fashionable topic in both the academic and business worlds. That is not to say that creativity did not exist before, but its importance to the continued success of an organization had yet to be recognized. The following sections outline the benefits of creativity in organizations.

Proctor (2019) pointed out that "Mindset" is a condition where an individual is over-sensitized to some part of the information available at the expense of other parts. Entrepreneurs need to be mindful of the current Mindset to avoid blocking creativity.

- There can only be one way to do it properly?
- This is what we have always done?
- Things are not that bad, why change?

9.2.2.1 Creativity for Problem Solving

In organizations, problems arise as different or new situations present themselves and they often require novel solutions. Frequently, it is difficult to see solutions to problems by thinking in a 'conventional fashion'. Logical thinking takes our existing knowledge and uses rules of inference to produce new knowledge. However, because logical thinking progresses in a series of steps, each one dependent on the last, this new knowledge is merely an extension of what we know already, rather than being truly new. It would seem, therefore, that logical thinking has only a limited role to play in helping managers to be creative.

Many management problems require creative insights to find satisfactory solutions. Nowadays, most organizations are fully aware of just how vital creativity is to their prosperity. Over time, considerable research has been undertaken which enables us to obtain a better understanding of creativity and become more innovative ourselves.

Ackoff and Vegara (1988) outlined that a company must respond creatively to the problems it faces to both external and internal environments and managers need to discover new and better ways to solve problems. For example:

- How to cope with slow economic growth;
- How to deal with new entrants to an industry;
- How to grow sales at the pace of competition in high-growth markets;
- How to deal with new technological developments; and
- How to cope with shorter product life-cycles.

Proctor (2018) emphasized the need for creative problem-solving has arisen because of the inadequacies of logical thinking. It is a method of using imagination along with techniques which use analogies, associations and other mechanisms to help produce insights into problems. Another study conducted by Majaro (1991) highlighted that "it is universally assumed that enhanced creativity can provide a company with a competitive edge".

9.2.2.2 Creativity in Management

Creativity in management is important as highlighted by James March (1988) because organizations face many problems, which only have a few solutions. To identify and solve the problems arising in business, challenging the problem-solving capabilities of those in charge becomes essential. When using the creative process to approach problems, it is necessary to restructure and redevelop the process to produce new ideas and perspectives.

Rogers (1996) stated that unless a company is progressing all the time, it is in fact moving backwards. It is quite impossible to maintain the status quo. Attempting to do things in the same way as they have always been done in the past can lead to difficulties in a business environment which is experiencing rapid cultural, economic or technological change.

9.2.2.3 Creativity and Competition

The rapid growth of competition in business and industry is often quoted as a reason for wanting to understand more about the creative process. Due to more business opportunities led by the increasing globalization and technology development, creativity becomes critical for the entrepreneur to gain competitive advantages for an organization.

One of the key aspects of any organization's success or failure is its ability to stay ahead of the competition in a rapidly changing environment. The modern business, with its emphasis on competition, building larger markets, strategic planning, team working, etc., has created the need for new problem-solving and decision-making strategies. Oldman and Cummings (1996) argued that it is important to encourage and promote employees' creativity in order for an organization to achieve competitive advantage.

S9.2.3 Entrepreneurship Mindset

The correct mindset is the most crucial factor in a successful entrepreneurship. Mindset is traditionally known as "a set of attitudes held by someone" that determines the path that will be chosen. It is important in entrepreneurship as what path is chosen can ultimately determine whether entrepreneurship succeeds or fails. Research has shown that mindset is not set and there is possibility for change. Stanford University Psychologist Carol Dweck proposed that there are two types of mindsets:

1. **Fixed Mindset** is the held assumption that people's talents and abilities are set traits, unchangeable and therefore seek to avoid challenges, failures or looking bad in front of family, friends or strangers.
2. **Growth mindset** is the held assumption that their abilities can be developed through dedication, effort and hard work and therefore seek to enhance their qualities despite the possibilities of challenges or failures, which may only inspire them to learn and try again.

Both types of mindsets are important in entrepreneurship. A fixed mindset that succeeds in entrepreneurship is based on luck but those that have a fixed mindset unattuned for entrepreneurship need to shift to a growth mindset to move past the fear of challenges or failure and instead learn from them and achieve success, no matter how many failures may occur.

Conclusion

Creativity is a vital asset for any person who is in a leadership role and an important human resource which exists in all organizations. Organizations must try to make use of this resource by developing a culture that facilitates and permits creative talents to thrive. Creativity leads to innovation, which is vital for the short and long-term survival of any organization, economy and society.

Reflection Questions

Q1) Explain how to develop the habit of creativity?
Q2) Explain two theories of creativity?
Q3) Why is it important for organizations to be creative?
Q4) Describe the two types of mindsets? Use examples.

Compulsory Reading

- *Neck, H. M., Neck, C. P., & Murray, E. L., (2017). Entrepreneurship: The Practice and Mindset. Sage Publications. (Chapter 3, p63-83 and Chapter 7, p.192-193).*
- *Key Terms Table (Appendix 1)*

Additional Readings

- *Proctor, T. (2006). Creative Problem-solving for Managers: Developing Skills for Decision Making and Innovation. Taylor and Francis.*

S9.3 Innovation and Entrepreneurship

Introduction

Entrepreneurship and innovation become increasingly important for both business and government. Established organizations innovate to respond to their competition or to have a competitive advantage. In the public-sector innovation is needed to develop effective policies to deal with the new economic, technological or social challenges. Innovation and entrepreneurship are recognized as key building blocks of competitive and dynamic economies (e.g., World Bank).

There are many different definitions of what innovation is, for example Rogers (1995) defines innovation as an idea, practice, or object that is perceived as new by an individual or other unit of adoption, while Kline and Rosenberg (1986) defines innovation as an exercise in the management and reduction of uncertainty. The latter definition includes uncertainty as a key concept: in fact, innovation is defined as an “exercise in the management and reduction of uncertainty” (Kline & Rosenberg, 1986, pp. 275-276). Uncertainty cannot be eliminated at any phase; however, uncertainty does vary along the production cycle, with a higher level of uncertainty at the development phase and decrease in the production and distribution phases.

S9.3.1 Types of innovations

Innovation is defined as the process and implementation of a new significantly improved product or service such as new product range, improving production methods, new advertising campaign, or new logistics system (OECD, 2005). Innovation can be considered along with several different dimensions for an organization to pursue, and there is not one single correct way to innovate.

Figure 3.1 outlines some of the different modes of innovation:

Business Model Innovations	Business model innovation is the development of new, unique concepts supporting an organisation's financial viability, including its mission, and the processes for bringing those concepts to fruition.
Market Innovation	Marketing innovation is the implementation of a new marketing method involving significant changes in product design or packaging, product placement, product promotion or pricing.
Organizational Innovations	Organisational innovation means the implementation of a new organisational method in the undertaking business practices, workplace organisation or external relations that are based on organisation methods already in use in the undertaking, changes in management strategy, mergers and acquisitions.
Process Innovations	Process Innovation means the implementation of new or significantly improved production or delivery methods, including changes in techniques, processes, equipment and the use of new software.
Product or Service Innovation	The introduction of a new product, service or improvements in functional characteristics, technical abilities or any other dimension.
Supply Chain Innovation	Supply chain innovations combine developments in information and related technologies with new logistic and marketing procedures to improve operational efficiency and enhance service effectiveness (Bello et al 2004).
Brand and Communication Innovation	A new and better ways of representing your organization.

Figure 3.1 Types of Model Innovations

S9.3.2 Innovation Theories

Innovation itself can be viewed as a multidisciplinary field of study, with several different models, theories and frameworks. Listed below are some of the most commonly used theories:

- Disruptive Innovation Theory
- Chain-linked Innovation Model
- Diffusion Innovation Theory

Disruptive Innovation Theory

The theory of disruptive innovation was developed by Clayton Christensen in 1997 and has had a great influence on the management practice. Christensen (1997) argues that the aim of innovation is to transform an existing market or sector by enhancing accessibility, simplicity, convenience, and reducing costs where complication and high cost are industry standards.

As Christensen (1997) highlighted, disruptive technology is a technology that offers value which differs from mainstream technology, and initially falls below mainstream technology in terms of performance, which is most essential to mainstream customers. In other words, disruptive innovation makes products and services affordable and more accessible — thereby enhancing living standards.

In the early stages of development, each product based on a disruptive technology can only serve a niche market that values its nonstandard performance attributes. (Christensen, 1997). Compared to existing market-leading companies, outsiders and entrepreneurs in startups are more likely to produce disruptive innovators.

Chain-linked Innovation Model

Kline and Rosenberg (1986) developed the chain-linked innovation model. Their model outlines the technical activities and interactions within each innovation process and depicts the feasible phases of the process, including the determining factors and how they are interconnected.

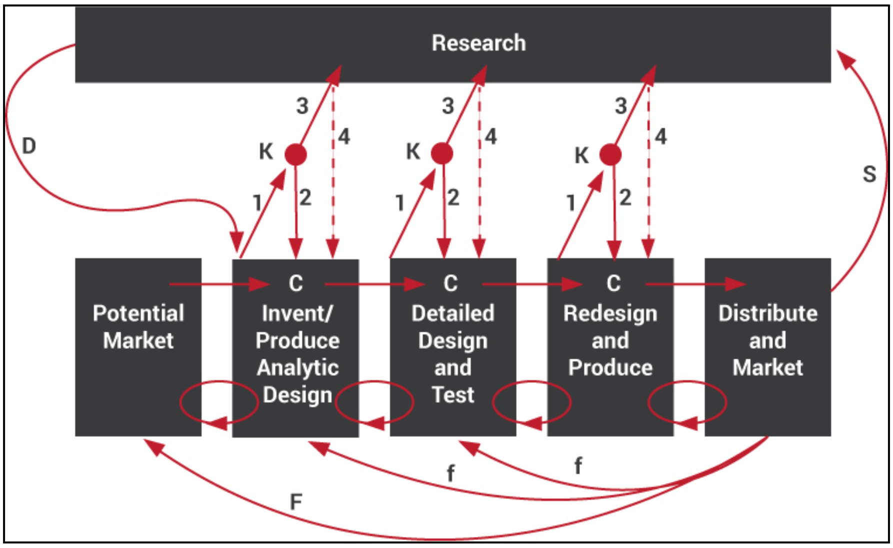


Diagram 3.2 Chain-linked Innovation Model
Extracted from: Kline and Rosenberg (1986) – Page 290

Diagram 3.2 outlines the five major paths of innovation processes:
The innovator goes to the pool of knowledge to find a solution and solve a problem (1), comes back with this knowledge and continues along the innovation chain if the needed knowledge is available (2) or resorts to research (3) if it is not; the results of the research activities are then used in the innovation chain (4). Finally, innovation results feed back into the scientific arena (S) (Kline & Rosenberg 1986, pp 275-276).

The central chain of innovation begins with the invent/produce analytic design phase (C), as a result of market research (D), which is also used as an input for following phases: design and testing; redesigned and production; and distribution and marketing. The process also includes feedback loops (F, f) repeating the steps and controlling for perceived market signals and users' needs, and connecting science and innovation (K), representing the recourse to various knowledge stocks accompanying the entire process (Kline and Rosenberg 1986, pp 275-276).

In this model, 'market-pull' and 'technology push' aspects of innovation are interdependent. Assuming the firm has knowledge and expertise, it will only invest if there is demand for the new innovation.

Diffusion of Innovations Theory

Rogers (1962) developed the Diffusion of Innovations theory which focuses on understanding how innovation and technology are adopted in a social system and the reasons why and at what rate adaptation occurs.

Robinson (2009) offered three valuable insights into the process of social change in the diffusion of innovations:

1. The determinants making an innovation spread successfully
2. The importance of peer-peer conversations and peer networks.
3. Understanding the needs of different user segments

The determinants making innovations spread successfully

Robinson (2009) highlighted that diffusion of innovations takes a radically different approach to most other theories of change by focusing on persuading individuals to change, it views change as evolution or "reinvention" of products, processes and behaviors so they become better for the needs of individuals and groups.

Table 3.1 below outlines five qualities that determine an innovation's success.

Quality	Description
1 **Relative advantage**	This refers to the extent to which an innovation is perceived as superior. Measured in terms of comparative advantage, social status, convenience, or gratification.
2 **Compatibility with existing values and practices**	This refers to the level to which an innovation is believed to be consistent with past experiences, and the needs of potential adopters. The innovation will only be accepted if there are no conflicts with the adopters existing values and practices.
3 **Simplicity and ease of use**	This refers to the degree to which an innovation is believed to be a challenge to use or maintain, meaning it will require the adopter to develop new skills and understandings. However, the simpler an idea the faster it will be adopted.
4 **Trialability**	This refers to the opportunity for an innovation to be tested on a limited basis. If the new innovation can be tested, it will be perceived as less risky to the individual.
5 **Observable results**	Visible results of an innovation will reduce uncertainty and encourage peer discussion of a new idea, as friends and neighbors of an adopter often ask for information about it.

Table 3.1 Five qualities that determine the success of an innovation
Extracted from: Robinson, L. (2009, p. 2). A summary of Diffusion of Innovations. Retrieved from https://www.enablingchange.com.au/Summary_Diffusion_Theory.pdf

The importance of peer-peer conversations and peer networks

Robinson (2009) outlined that impersonal marketing methods like media stories may be a more useful method of spreading information about new innovations, because it causes individual or group conversations, to reduce risk and uncertainty and encourage adoption. The adoption occurs when people we personally know, and trust provide us with useful information it reassures us that it is a good idea to adopt the innovation. However, early adopters are the exception to this rule, because they are willing to take risks and may be financially more secure. Early majority and Late majority are more risk averse and will not take risk unless they have reliable assurance from trusted peers (see Diagram 3.3).

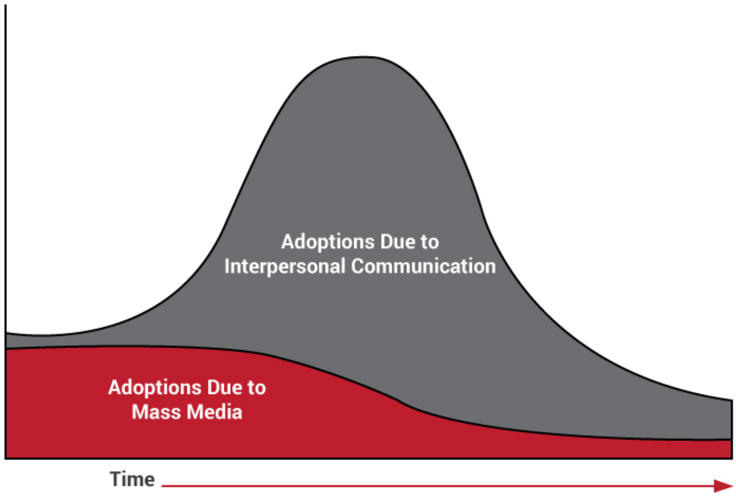


Diagram 3.3. The Bass Forecasting Model
Source: Mahajan and Bass (1990) as reproduced in Rogers, EM, (2003, p.201)

Robinson (2009) noted that an innovation spreads from early adopters to majority audiences. Face-to-face communication therefore is more important to the decision to adopt. (See Diagram 3.4.) Many Marketing campaigns utilizing peers to promote new innovations in their own social networks and to encourage adoption, for example recruiting opinion leaders, doctors and celebrities can be considered standard practice.

Understanding the needs of different user segments

Robinson (2009) explained that diffusion researchers have broken down the population into five different segments (see Diagram 3.4):

1) Innovators,
2) Early adopters,
3) Early majority,
4) Late majority,
5) Laggards.

Each group has its own characteristic or "personality", according to innovation. Each segment is static— To evolve to meet the needs of successive segments is the best way to spread innovations (Robinson 2009, p. 3).

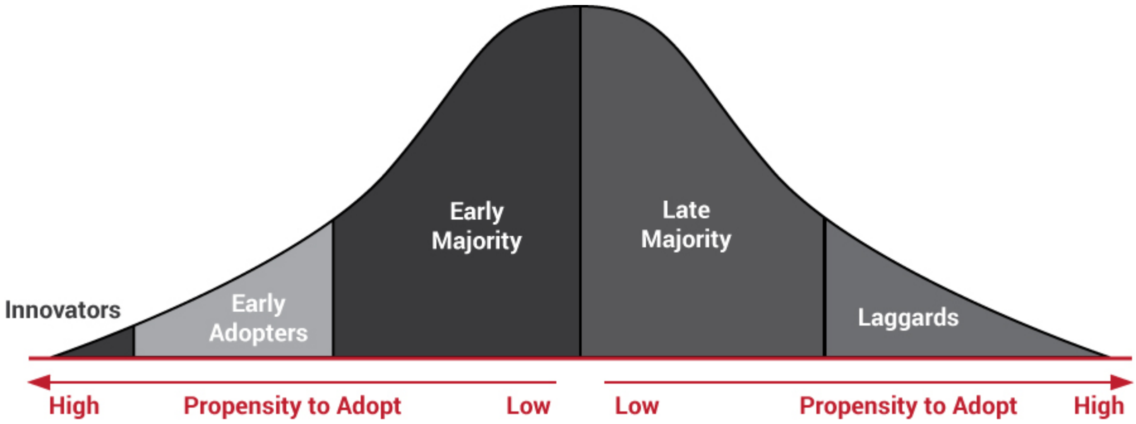


Diagram 3.4: The Bass Forecasting Model
Extracted from: Robinson (2009, p.3)

Compulsory Reading

9.3.2.1 Innovators

The adoption process begins with a few innovators, they are the first in your circle of friends to have the latest iPhone, Apple Watch, or book a ride with Uber, while others warned against it and used taxis. Unfortunately, their determination or obsession to have the latest new behavior or gadget can make them seem dangerously idealistic to the more conservative groups, however no innovative organization can thrive without their determination and obsession.

Work with innovators:	• Oversee innovators and provide support and publicity for their ideas. • Include innovators the design process of your project.

9.3.2.2 Early adopters

After Innovators comes the Early Adopters who are the second phase of product purchasers. These people tend to be the most influential within any market and will often have a degree of thought leadership for other potential adopters. They are constantly on lookout for clever innovations which will enhance their personal or business lives. Robinson (2009) explained that early adopters have a reasonably high social status, are economically successful and they’re often fashion conscious and adore leading trends. Consequently, they thrive on getting an advantage over their peers. Their natural desire to be trend setters causes the “takeoff of an innovation” (Robinson 2009, p.6). Early adopters play a very important role in the adoption process, as they are easily persuaded to test innovations and look for ways to get a social or economic edge.

Work with early adopters:	• Facilitate for early adopters to try the new innovation and train them as per educators. • Research each of the trials carefully to identify how to make the idea more adoptable. • Reward the early adopters with media coverage. • Get their feedback regularly.

9.3.2.3 Early majority

As the product starts to attract mass market, the next class of adopter to arrive is the early majority. Early majorities are rational thinkers who are cost sensitive and risk averse, comfortable with the status quo, but won't act without solid proof of benefits. They make decisions based on reliable information, "industry standard" and "endorsed by normal, respectable folks". This means that early majorities are sensitive to cost and hate risk, thereby requiring guaranteed off-the-shelf performance, the lowest level of disruption, minimum commitment of time and learning, and either cost neutrality or rapid payback periods (Robinson 2009. p.7).

Work with the early majority:	• Promote the product to stimulate interest and use reliable sources, including highlighting how the innovation complies with industry standards – if applicable. • Provide clear instructions to maximize usage and offer money back if the innovation does not deliver expectations. • Provide strong customer service and support.

9.3.2.4 Late majority

Robinson (2009) emphasized that the late majority are risk adverse compared to innovators, early and majority adopters. Comparatively, they are more conservative and will follow mainstream fashions and established standards due to the fear of not fitting in.

Work with the late majority:	• Promote social norms, as they are concerned with fitting in and do not want to be left behind • Make the product convenient and affordable.

9.3.2.5 Laggards

Robinson (2009) explained that laggards hold out to the end, they are risk adverse in adopting a behavior or new product, as they do not want to make mistakes. Robinson argued that in the early stages' firms may be able to ignore the views of laggards, but not the late majorities, innovative firms need to address their concerns, because late majorities share many of their views.

Work with laggards:	• Promote the innovation and highlight how others have benefited from it. • emphasize that there is no risk and that they can choose when, where and how to adopt the innovation.

Important note:

It is important for an entrepreneur to understand that each of these adopter personalities are very different (e.g., no one is an innovator or a laggard about all new ideas) and to know which one you are addressing at a given time and that usually can't address them all at once.

S9.3.3 Paradigm Shift

A paradigm is a perception or a group of ideas about how things should be done, made, or thought about. For example, a paradigm is a set of rules and regulations that define boundaries and help us to be successful within those boundaries, where success is measured by the problems solved using these rules and regulations. Paradigm shifts are different from continuous improvement. A paradigm shift occurs when the old paradigm is transformed or disrupted by a new way of thinking, or a new belief, which leads to a significant change in the perception of an individual or a group. Paradigm shifts have made it possible for your smartphone to be millions of times more powerful than all of NASA's combined computing in 1969 and cost much less compared to $3.5 million a per computer and were the size of a car (Puiu 2019). Paradigm shifts lead to opportunities for disruptive innovation to occur, including new products and services, new approaches and new business models

Procter (2013) outlined that Paradigms have life-cycles, and towards the end of the life-cycle problem-solving becomes costlier, more time-consuming and less satisfactory.

Examples of paradigm shifts include (see Table 3.2):

- Paradigm shift in business strategy
- Paradigm shift in design and use of technology
- Paradigm shift in the role of senior management
- Paradigm shift in organizational knowledge processes
- Paradigm shift in organization design

Compulsory Reading

Paradigm Shifts

Paradigm Shift	Description
Paradigm shift in business strategy	In the new world of business, instead of long-term prediction, the emphasis is on understanding the multiple future world-views by using techniques such as scenario planning.
Paradigm shift in design and use of technology	This involves the shifting from the current production methods or the use of new technology that enhances efficiency.
Paradigm shift in the role of senior management	The new emphasis should be on building commitment to organizational vision rather than compliance to rules and pre-specified best practices. Senior managers need to promote and make the organizational information base accessible to the members of an organization.
Paradigm shift in organizational knowledge processes	Institutionalization of 'best practices' by embedding them in information technology might facilitate efficient handling of routine and predictable situations. However, managers need to encourage and promote creativity and innovation to enhance knowledge in the organization.
Paradigm shift in organization design	While traditional business logic was based on a high level of structure and control, the new approach demands a different model of organization design. This model is characterized by relative lack of structure and lack of external controls. Differences in perspective may have a very positive role in innovation that feeds new product and service definitions and business models. This view encourages promotion of individual autonomy in experimentation and learning environments.

Table 3.2: Paradigm shifts in organizations

Extracted from: Proctor, T. (2013, p.70-72).

Conclusion

In a competitive environment, change is the only constant. Innovation is a source of competitive advantage among firms and nations. Creativity and innovation can also play a role in starting new businesses by providing infrastructure that was previously lacking and enable entrepreneurs to overcome infrastructure barriers. Therefore, the goal of an entrepreneurs in an organization is to cultivate a culture of creativity and innovation.

Reflection Questions

Q1) Define disruptive theory and provide an example?
Q2) Discuss the five stages in diffusion theory and their importance in decision making.
Q3) Using real world examples, explain three types of model innovations.
Q4) Innovate or die. An extreme standpoint perhaps, but it does indicate the dire consequences facing organizations that fail to innovate. Evaluate and discuss.

S9.4 Innovative Organizations

Introduction

Innovate or die. An extreme standpoint perhaps, but it does indicate the dire consequences facing organizations that fail to innovate. Innovation is a key drive for many organizations to gain growth and competitive advantages. Innovation is important for an organization's survival and longevity and should be a core value or as a part of company vision and mission statements. Achieving innovations requires a multi-disciplinary approach, including the co-ordination efforts of many different individuals and the integration of activities across specialist functions, knowledge domains and context of application.

S9.4.1 Organizations Approach to Innovation

As discussed in section 3, there are different types of innovations: business model innovations; market innovation; organizational innovations; process innovations; product or service innovation; supply chain innovation; and brand and communication innovation — that will ensure the organization's survival. Regardless of the type of innovation, the organization can take two approaches to innovation, incremental or radical. Usually, this will depend on how much time and money you have available and what the business strategy is. These approaches can be part of a continuous cycle or employed on a more ad-hoc basis, depending on your needs.

- **Incremental innovation**
  Incremental innovations involves enhancements or modifications to existing processes, product or services. The purpose of these modifications is to enhance operational efficiency and gain a competitive advantage. For example, Apple's iPhone or Coca-Cola's line extensions such as Cherry Coke and Coke with lime.

- **Radical innovation**
  Radical innovation involves creating a completely new process or product in response to a market need or opportunity, for example, new markets can be created as a result.

- **Combining radical and incremental innovation**
  Sometimes the best approach can be to combine radical and incremental innovation. An example of this would be to develop a totally new process to produce and manage an existing product or service.

S9.4.2 Driving and Implementing Innovation

Most corporate leaders understand that innovation is essential for survival in today's business world. The definition of innovation varies among business leaders, but there are several common practices for promoting a culture of innovation:

- **See Failure, as an opportunity to Learn and Grow**
  To drive innovation, leaders must be more tolerant of risk, avoid perfectionism and be supportive to innovative team members. Not every attempt will lead to success, creativity is all about failure so don't punish mistakes— learn from them—the goal is to get the new offering to market as quickly as possible rather than to achieve perfection. An organizational culture that sees failure as an opportunity to grow will be productive and innovative.

- **Provide the Right Rewards**
  To encourage innovation, leaders must support, acknowledge and reward individuals. Some examples of rewards in innovative companies include:
    - ✓ Rewarding people for working on an idea, even if it does not get to the execution stage.
    - ✓ Holding brainstorming meetings without the organization's senior figures to encourage people to verbalize their innovative ideas.
    - ✓ Allowing employees to write and apply for research grants to carry out projects that are important to them.
    - ✓ Holding weekly process improvement meetings that invite ideas from everyone in the company.
    - ✓ Having formal recognition programs that include nominations and/or votes from colleagues, with innovation as one of the nomination categories.

- **Build a Diverse Team**
  Diversity in the workplace provides a wider range of knowledge and skills, which can be applied to any project. Other benefits of diversity include employee engagement, reduced staff turnover, improved creativity and efficiency.

Cultivate Connections with External Stakeholders

Successful leaders know that innovation ideas can come from internal and external stakeholders. Innovation management involves the strategic management of all stakeholders in the innovation process and phases, consequently enhancing likelihood of the acceptance of the new innovation.

- **Identify and Develop Leadership Competencies that Drive Innovation**
  Some of the competencies that are associated with driving innovation include emotional intelligence, social intelligence, analytical capabilities and technical competencies. Emotional skills and the ability to have a vision are often thought of as the most important.

- **Implementing Innovation**
  Effectively implement innovation involves a set of core functions and processes that are vital for organizational innovation. Table 4.1 outlines the key perceptions.

S9.4.3 Think Tank

A think tank is an organization that supports scientists and intellectuals and their research on specific problems, with the aim of finding solutions. Listed below are five strategies that can be useful for organizations.

1. **Combine ideas.** Brainstorming to combine ideas that may result in better outcomes.
2. **Think backwards.** Starting with an end product in mind and working back toward the first design stage and production.
3. **Do rapid-prototyping**. Create a simple experimental model of a proposed product or solution.
4. **Create an internal fund.** Encourage employees to network and peruse ideas that otherwise wouldn't have a budget.
5. **Take it online processes.** Idea management software that can make brainstorming more effective.

Concept	Description
Shared perceptions regarding innovation	• Innovation as a strategic priority (benefits and opportunities) • Innovation serves for a competitive advantage • Innovation requirements are clearly defined • Initiating innovation and supporting it are defined as desired traits, which are acknowledged and rewarded
Human efforts invested in innovation:	• Leadership commitment Vision: Well communicated, clear strategic vision and goals • Innovation dedicated leaders: innovation personas setting motivations and inspirations • Engaged employees that care to promote innovation processes and outcomes • Cross organization employee involvement (cross departments and roles) • Innovation agents and external partners are involved in innovation activities
Tools and platforms	• Inspirational tools and creative settings • Innovation learning tools • Internal innovation communication channels / platforms • Innovation performance metrics (measurements and follow-ups for improvement) • Innovation incentives and rewards • Structuring the innovation intervention process
Process for innovation implementation:	• Identification of worthy innovation challenges (incremental and disruptive): portfolio balance, short and long-term expectations, risk and success assessment. • Identification of innovation obstacles for specific projects • Managerial involvement and support • Wide collaboration teams (diversity of roles, departments, sectors, regions) • Supporting the process through the 4 stages: Ideation – selection – development - and commercialization • Initiation of innovation projects (communication efforts are included) • Agile project management (execution planned and emphasized from the early start) • Re-examining innovation projects (updating risk and benefits) • Lesson learning • Communication of shared innovation experiences (successful projects as well as failed ones)

Table 4.1 Organizational innovation key perceptions

Extracted from: Weiss (2013) Innovation Starts within: Implementing Innovation in Organizations. Trends Spotting Blog. Retrieved, http://www.trendsspotting.com/blog/?p=2298

S9.4.4 The Power of Storyboarding

Storyboarding is an easing form of prototyping that provides a high-level view of thoughts and ideas arranged in sequence in the form of drawings (see diagram 4.1), sketches or illustrations. Entrepreneurs can benefit from storyboarding as it gives them a better understanding of their ideas and how it interacts with their customers. It allows everything to be compiled into an easy to understand visual and logical document(s). It is especially useful when used before interacting with customers and stakeholders, as it brings clarity of the potential value and problems of an idea.

Diagram 4.1 The Problem—Solution—Benefit Framework
Extracted from: Neck et al. (2017, p193)

Compulsory Reading

S9.4.5 How to Manage Creative Teams

Working with “left-brained” (more analytical) versus “right-brained” (more creative) employees has its own set of rules. The right-brain is more visual, emotional and has a somewhat impulsive style of learning. Right brain dominant people are artistic and innovative and like to begin with a wide overview which they then narrow down to very small details. While left-brained people are more verbal and logical and prefer things in order and prefer a formal workplace. Listed below are some ideas to encourage creativity:

1. Develop ideas
2. Brainstorm
3. Foster a creative workspace
4. Provide constructive feedback
5. Develop style parameters
6. See failure as an opportunity
7. Effective communication

Today’s workplace is filled with different personality and learning styles. Having a good understanding about individual differences and how they affect the workforce can make enhance team’s productivity and make you a more effective leader.

Different is Good

Diversity is good — we are all unique and different and have different styles of thinking, learning and communicating. Learning to benefit from diversity in the workplace can enhance creativity and efficiency.

Emphasize Lifelong Learning

Technology is dynamic and improves the processes and techniques in the workplace. It is important to make sure everyone in the organization enhances their knowledge and keeping up with the latest technology and techniques. This can be achieved by sending links to new ideas or online articles, and providing learning materials, industry magazines and training to all staff.

Start Daydreaming

Daydreaming is at the core of problem-solving, when your employees zone out at their desks; sometimes that is ideas are forming and when the creative process is happening. While every organization wants creative employees, managing creative people is easier said than done. There is proven methodology to develop the right workplace environment and keep everyone happy and productive. It is the responsibility of the manager to encourage and support employees to think out-of-the-box.

1. ***Develop Ideas***
   In order to develop ideas, teams need to collaborate. This starts with a collaborative and supportive environment. This means avoiding criticism and removing constraints on how and what a project should look like. Communication is important, as it helps in ensure that the project is on track and helps to identify and manage any risks that may arise.

   A trait that makes creative people successful in creative and design-oriented fields is that they do not just follow a set of rules but are free to think outside the box. Managers should avoid planning out everything that should be done without any flexibility, give employees the opportunity and freedom to make choices so they feel creative and in control of their projects. In addition, provide employees with support and coaching, instead of just setting rules for them.

2. ***Brainstorm***
The creative process is often organic, and it involves creative people thinking and imagining. Brain storming can be beneficial for right-brained thinker as they are good at processing information. Follow the ‘no idea is stupid rule’, either keep them or toss them out, and take notes of concepts that are workable.

3. ***Foster a Creative Workspace***
A dull workspace will not foster creativity. Inspiring workers can be as simple as changing up the workspace by adding color and items, putting up interesting artwork and even playing music at appropriate times of the day. One of the world’s most successful companies, Google, is known for its colorful and modern workspaces.

4. ***Provide Constructive Feedback***
It is important to let your employees know how they are doing. When providing feedback, keep the focus on the employees’ work and make sure to choose your words wisely, especially for those with a right-brained style of thinking as they are more likely to become emotionally attached to their work. The nature of any creative field is that much of what ‘works’ or does not, comes down to a matter of personal preference. The fact is that people have different preferences and styles therefore it is important to remember that you are not going like everything that comes to your desk. Setting clear boundaries in black and white areas and setting a clear set of steps to meet goals can be beneficial.

5. ***Develop Style Parameters***
It is a good idea to have and post some technical specifications, guidelines and communication standards set in place, even if creative writers like their space. Some types of work that deal with visual consistency, such as design in magazines, newspaper and some websites, require a basic set of style rules. Other rules include acceptable fonts and colors as well as guidelines for images. Guidelines for the breaking often should also be set, including the threshold and who approves of the ‘rule-breaking’.

6. ***See Failure as an Opportunity***
Failure is inevitable, so don’t take work away from an employee after a failed project, give them an opportunity. The most successful companies do not criticize failure as they do not want to create risk-averse employees who are afraid to come up with new ideas and try new things.

7. ***Effective Communication***
   It's often the case that visual people have difficulty communicating with non-visual workers. During a conversation or meeting a visual group may be able to 'see' an idea while others cannot. Such visual workers must be coached to better communicate their ideas, use visual aids and use stories to connect with the audience. Questions should also be asked to help visual learners to better express their thoughts. For example:
   - I don't understand?
   - Can you run through it one more time, so I can get understand it?
   - Can we use diagrams to make sure we are on the right track?

S9.4.6 IT Systems for Innovation

Idea Management Systems is a tool which can be used by employees from all geographic locations within an organization to submit, evaluate, and engage in discussions around innovative ideas (Cedernaes & Eriksson, 2012). These systems have a structured process which allows managers to evaluate ideas and select the ideas with the greatest potential. Additionally, Idea Management Systems is a useful tool for developing new product and service ideas but can also catalyze greater results from corporate cost-reduction initiatives; therefore, involving other stakeholders to contribute to ideas will only enhance the benefits for everyone. Due to the innovative nature of idea management systems organizations that have implemented this technology can compete at levels never possible.

Idea management systems typically offer the following:

- **Campaign focused:** Organizations can set up specific projects within the software — such as coming up with new ideas for a specific product line. A larger number of high-quality ideas can be collected when the ideas are for a specific business objective.
- **Capturing ideas:** Ideas can be inserted into the system by changing the input forms to meet the specific needs of the project.
- **Evaluation criteria:** Idea management systems have a customized numeric scale allowing the evaluation of ideas for projects. This ensures that all ideas can be rated more consistently.
- **Evaluation workflow processes**: If an evaluator feels that they lack the skills and ability to properly evaluate an idea, an expert with specialized knowledge can be called upon to provide feedback.
- **Collaboration and idea sharing**: The leading idea management systems have the option for employees to view and comment on the ideas of others. This peer review process facilitates to structure ideas into solutions.

Conclusion

Innovation is the source of organizational growth and competitive advantage. Both managers and researchers know that innovation determines the success of an organization and enhances the ability to respond to economic and environmental change faster than non-innovative organizations. Innovation is not a one-off activity but an ongoing internal process that ensures the organizations remains competitive.

Reflection Questions
Q1) What are the benefits of using the Storyboarding framework?
Q2) What is the differences between incremental and radical innovation.
Q3) List the common practices for promoting a culture of innovation.
Q4) Define and explain using examples: A) Think tank; B) Storyboarding; C) Idea Management Systems

S9.5 Entrepreneurs and Corporate Intrapreneurs

Entrepreneurship involves developing a new venture outside an existing organization whilst intrapreneurs are known as corporate entrepreneurship which is a relatively new concept that focuses on employees of an organization that has many of the attributes of entrepreneurs. An Intrapreneur can be defined as an employee that takes risks to solve a given problem, develops a new venture within an existing organization, exploits new opportunities and creates economic value. There is evidence that intrapreneurship helps managers to renew and revitalize their business, to innovate, and to enhance the organization's overall performance (Antoncic and Hisrich 2001). Intrapreneurship is an important element in organizational, economic and social development.

S9.5.1 Similarities and differences between entrepreneurship and intrapreneurship

The intrapreneur is innovative and aims to change and renew processes and systems within the organization. The problem with this is that it may cause conflicts within the organization, so caution is necessary to channel these conflicts and transform them into strategic solutions for the organization.

Compulsory Reading

While intrapreneurs benefit from using the resources of the organization for the implementation of the strategic opportunities that can benefit the organization, the intrapreneur has the following challenges:

- **The size:** can increase agency cost.
- **Unproductive communication:** Specialization and separation hinder communication.
- **Internal competition:** Prevents information sharing. Internal competition amplifies the problem because instead of collaborating, everyone is working for their own interest.
- **Lack of acknowledgement:** Lack of acknowledgement of success and/or poor feedback on failure or mistakes. Costs in the case of failure are severe and the reward for a successful is too small. Intrapreneurs must be supported through success or when they make mistakes, as mistakes are an unavoidable part of the innovation process.
- **Fear of change:** Many companies are slow and are reluctant to change. Intrapreneurs bump many times into the well-known sentence 'We always did it this way', which leaves little or no space to creativity. Change is only encouraged when the company is facing challenges, but even so they don't give room to an innovative leadership.

- **Organizational Hierarchies:** Organizational hierarchies prevent employees from actions that fall outside their daily duties. The more complex the hierarchy the more difficult it is to promote change, creating short-term thinking and a victim mentality due to a reduced area of action and reduced responsibilities.

Table 5.1 outline the entrepreneurship and intrapreneurs advantages and disadvantages. And Table 5.2 outline the similarities and differences

Entrepreneurship	
Advantages	Disadvantages
• **Entrepreneurs are their own boss, independent from company rules and regulations, allowing them freedom in determining work culture, schedule, dress code etc.** • **Their income increases as their innovation takes off** • **They have the chance to be original and creative in their own terms** • **They can fully immerse themselves with the excitement & adventure of innovation** • **There are a lot of possibilities for entrepreneurs** • **Entrepreneurs decide their own salaries**	• Money pressure – entrepreneurs give up the security of a regular pay check and rely on the help of investors and the potential profits • They take on all the risk alone • They receive less benefits as the business is new • They have long working hours • Their mistakes and errors are magnified, and they are unable to manage it • All of their decisions must be made alone
Intrapreneurship	
Advantages	Disadvantages
• **They have the privilege to stay in a friendly, helpful and well-known environment** • **They can practice their skills within an organization and incur lower risk by shifting to the over-seeing company** • **They can use the company's resources, information, good name, knowledge, legal team etc.** • **They have information about customers, infrastructure and reputation**	• Their reward may not be up to expectation and they would receive less glory (which would go under the company's name) • Their innovation may not be appreciated accordingly as the company would receive the recognition. • They can be innovative but only to a certain extent, they are not their own boss as they must follow the company's rules, regulations, work culture, schedule and dress code etc.

Table 5.1: entrepreneurship and intrapreneurs advantages and disadvantages.
Extracted from: Quizlet. (2016). Entrepreneurship unit one module one. Retrieved from https://quizlet.com/159957260/entrepreneurship-unit-one-module-one-flash-cards/, with Authors inclusions.

Similarities	Differences
• **Both require recognition and the ability to act on it.** • **Both require intelligence and skills to complete their projects.** • **Both require a unique business concept that takes the form of a product, process or service that puts them ahead of the competition** • **Both require strong leadership qualities.** • **Both are driven and have the emotional intelligence to motivate others and work effectively with a team to bring the project to fruition.** • **Both require a focused but balanced vision with managerial skill, passion with pragmatism, and proactiveness with patience.** • **Both require creative management and diverse approaches to their fields.** • **Both involve concepts that are most vulnerable in the formative stage, and that require adaption over time, due challenges or failures.** • **Both entail a window of opportunity within which the concept can be successfully capitalized upon, as competition becomes more likely.** • **Both require the prediction of value and risk** • **Both entail risk and require risk management strategies.** • **Both require the entrepreneur and intrapreneur to develop creative strategies for allocating resources.** • **Both involve significant ambiguity and flexibility.** • **Both require harvesting strategies, to reap maximum profits.** • **·Both require the ability to adapt and to shift direction quickly and effectively when problems arise.**	• In a start-up, the entrepreneur takes the risk, while the intrapreneur shifts the risk to the company rather than their career. • In a start-up, an intrapreneur has the backing of the company, allowing them to use company resources, legal advice and financial oversight. • In a start-up, the entrepreneur owns the business, whereas in intrapreneurship, the company owns the business with the individual intrapreneur having little or no equity in the venture at all. • In a start-up, potential rewards for the individual entrepreneur are theoretically unlimited, while in an intrapreneurship, an organizational structure is in place to limit rewards and compensation to the intrapreneur • In a start-up venture, one strategic error could mean instant failure for the entrepreneur, while in intrapreneurship the organization has more flexibility for management errors. • Intrapreneurs have no need to raise capital once the project is greenlit, they also have access to mentors and are able to learn from supervisors and other company personnel. • In a start-up the entrepreneur is influenced or more susceptible to outside influences, while in intrapreneurship, the organization is more insulated from outside forces or influences. • Entrepreneurs have more freedom in their venture, allowing them to determine work culture, schedule and dress code.

Table 5.2: Intrapreneurs vs. Entrepreneurs – similarities and differences

Extracted from: Quizlet. (2016). Entrepreneurship unit one module one. Retrieved from https://quizlet.com/159957260/entrepreneurship-unit-one-module-one-flash-cards/, with Authors inclusions.

How to create intrapreneurs
The literature has highlighted that intrapreneurs are important as they are value-creating which is essential for an organization's formulation and execution of strategy in today's knowledge economy (Antoncic & Hisrich 2001).

Listed below are some strategies for entrepreneurs to encourage and support intrapreneurship:

1. **Share the equity.**
   When employees own a small part of the company, they are much more heavily invested in the success of the organizations and more likely to become an intrapreneur.
2. **Support intrapreneurs.**
   Support intrapreneurs by providing support, time and resources. Teach them how the process works and assure them that the company supports them.
3. **Relax and have fun!**
   Be creative and have fun, a relax environment enhances creativity and willingness to contribute. Some companies have suggestion boxes or creative thinking workshops and ideas classes.
4. **Recognize the success of employees.**
   Employees need to be told that they are valued for their ideas and contribution and that their ideas are acted upon.
5. **Reward them financially.**
   Apart from being acknowledged for their efforts, intrapreneurs also need to be rewarded for their efforts in order to be motivated to continue to innovate.

S9.5.2 Entrepreneurial Problem Solving

Problems are simply an opportunity to grow or learn. Entrepreneurship is essentially about problem solving and while it is a complex activity and often requires different expertise, the good news is that problem-solving skills can be developed over time through education, practice and persistence. Listed below are some problem-solving skills that entrepreneurs need to develop.

Compulsory Reading

1. Critical Thinking Skills
It is common knowledge that the human brains potential is greater than previously thought, but unfortunately, only few people ever utilize their brain power. Brain capacify determines our critical thinking and consequently aids in problem solving. Napoleon Hill (1937) said that all achievements begin with an idea and ideas are the product of critical thinking. Critical thinking skills enables entrepreneurs to identify business challenges and problems and find solutions.

2. Understanding of the business

Critical thinking is important to the process of effective problem solving in business, however it is important to have a clear understanding of the business you are managing. You can enhance your knowledge and understanding by, reading books, listening to experts, attending seminars, and analyzing industrial trends.

3. Emotional Intelligence / People Skills

Another important component of problem solving is emotional intelligence. Finding solutions to business problems involves you thinking in solitude and as part of a team. The literature indicates that emotional intelligence and problem-solving skills are closely associated with each other (Deniz, 2013). Another study conducted by Salvoy et al. (2000) also highlighted that a greater emotional intelligence is useful for effective problem solving is as it enables people to see the problem from different perspectives.

4. Faith or Positive Attitude

Like emotional intelligence, a positive attitude is needed for finding a solution to any problem—Look and you will find, but you will only look if you believe you will find. Faith is important to critical problem solving because it keeps the mind focused on finding a solution to the problem; rather than lamenting over the problem.

5. Decisiveness

Decisiveness is also important for critical problem-solving. Entrepreneurs need to analyze several options and be able to arrive at a decision quickly. Decisiveness does not mean risky behavior, but it is an attribute that reflects the ability to make choices between alternative courses of actions to achieve a desired outcome.

6. Courage

Another important skill that entrepreneurs need to have or develop is courage. Effective problem solving requires courage—first to acknowledge the problem, then to decide the best solution for it and have the courage to face the consequences of your choices.

Problem solving skills help entrepreneurs to solve obstacles in any situation. However, problems solving skills are enhanced if the entrepreneur has the following skills: critical thinking, understanding your business, emotional intelligence, positive attitude, decisiveness and courage, just like everything in life, skills are developed over time.

S9.5.3 Intrapreneurial Problem Solving

One of the biggest problems preventing organizations from innovating is the notion of “if isn’t broken, don’t fix it.” As discussed in section 1, intrapreneurship refers to an employee’s own interest in the improvement of something (process or product) in an organization, without being asked to do so. Hence, the intrapreneur uses its own creativity to innovate and transform an idea into a profitable project. Organizations need intrapreneurial problem solving skills; there are seven essential qualities that make a successful intrapreneur. Companies that want to be innovative, enhance productivity and have a competitive advantage need to enhance the entrepreneurial aptitude of their employees and need look for the following qualities. This list is only an example, as there are many other qualities that are important, however these are the critical ones for an intrapreneur to be successful.

- **Passionate**
  Intrapreneurs require purpose and passion for what they do, as it comes across in their actions, body language and their voice. Such passion will inspire others to help and join the Intrapreneur.
- **Determined**
  Intrapreneurs must believe in their vision and be determined to achieve it, especially when obstacles occur and when their ideas and credibility are questioned by others.
- **Courageous**
  It is important for intrapreneurs to be courageous when pursuing their goals and to not be afraid of failure, criticization or losing their job.
- **Resourceful**
  It is important for intrapreneurs to be resourceful by utilizing their current resources efficiently and using creative means to find resources without paying for them. This gives Intrapreneurs a competitive advantage and is a quality that every employee would desire.
- **Adaptable**
  Intrapreneurs require adaptability, as it is important for them to be able to turn any situation to their advantage. The use of creativity allows them to respond to changes around them. Despite the firm’s constraints of internal protocols and procedures, intrapreneurs are required to have the necessary skills required to maximize desired outcomes.
- **Results driven**
  Intrapreneurs need to focus on their tasks and goals, from the beginning to the end to ensure the delivery and completion of desired results. Therefore, Intrapreneurs need the ability to effectively and efficiently execute ideas.

- **Diplomatic**
  Diplomacy is one of an intrapreneurs most important qualities they need to master. They also need to have negotiation skills to avoid conflicts with people can that influence resources, decision making and recognition. Therefore, Intrapreneurs must disrupt markets and industries and not the people they rely on.

S9.5.4 Collaborative Networks

Collaborative networks are commonly recognized in society as a very important instrument for survival of organizations. Camarinha-Matos (2004) outlines that a collaborative network is constituted by a variety of entities (organizations and people) that are largely autonomous, geographically distributed, and heterogeneous in terms of their: operating environment, culture, social capital and goals (see Figure 5.1).

Collaborative networks (CN) are important the new knowledge driven society. With improvements in technology many collaborative networks have emerged, for instance, Noran (2009) highlighted that collaborative networks enhance the preparedness of their participants to promptly form virtual organizations that can successfully tender for large scale and distributed projects.

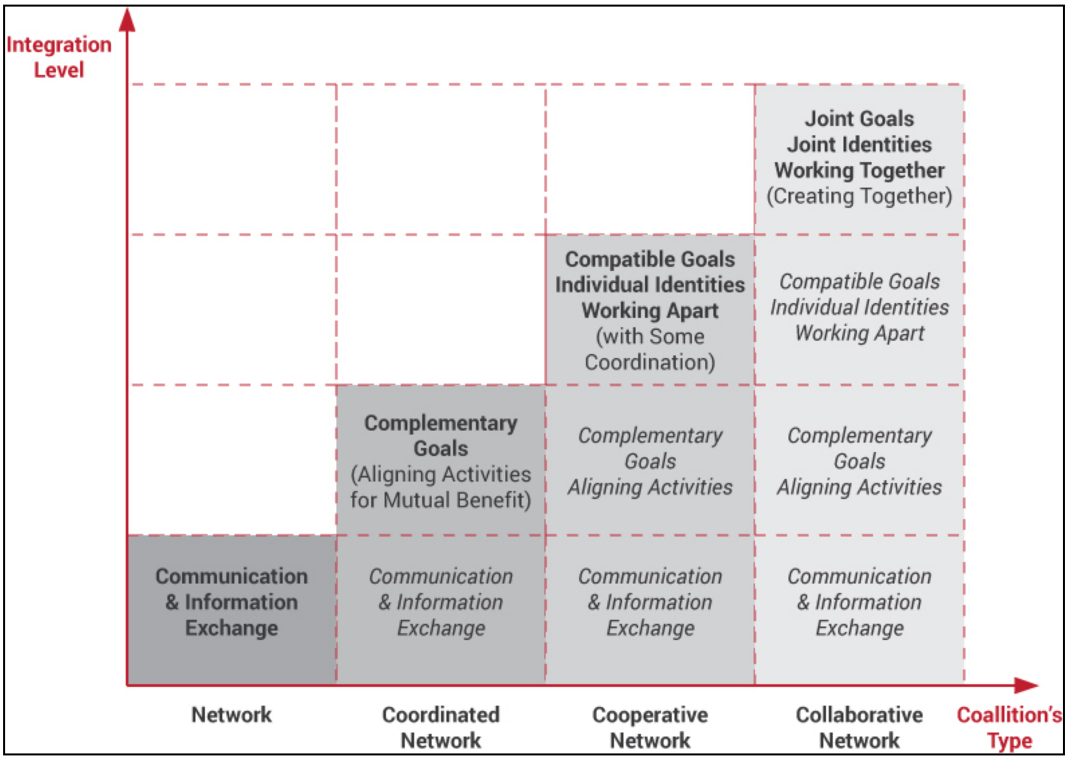


Figure 5.1: Examples of Joint Endeavor

Extracted from: Camarinha-Matos and Afsarmanesh, H. (2006, p.29).

Notion of Collaboration

The notion of collaboration appears to be almost universally accepted as being valuable as a way of encouraging learning, creativity and innovation. Organizational networks are informal networks of people within a company who actually interact with each other. There are different types of collaborations, Camarinha-Matos and Afsamanesh (2006) define:

- **Networking** as communicating and exchanging information for mutual benefit.
- **Coordination Networking** as aligning activities to achieve more efficient results.
- **Cooperation as exchanging information, adjusting activities, and sharing resources to achieve compatible goals**.
- **Collaboration** is the process of sharing information, resources and responsibilities in order to achieve a common goal.

Collaboration networks have the potential of bringing benefits to the involved parties and show a high potential as drivers of value creation. As presented in the given definitions and depicted in Diagram 5.1, each of the collaboration types constitutes a "building block" for the next definition:

- Coordination extends networking;
- cooperation extends coordination;
- and collaboration extends cooperation.

Camarinha-Matos and Afsamanesh (2006, p.29) highlighted that as "we move along the continuum from networking to collaboration, we increase the amounts of common goal-oriented risk taking, commitment, and resources that participants must invest into the joint Endeavor".

Innovative Business Model

Compulsory Reading

A business model is a system of activities that are interdependent and that create value for the stakeholders of the firm (Amit, 2014). Innovative business models facilitate better decision making, including meeting customer needs in an existing market, delivering existing products and services to existing customers with unique differentiation, and by serving customers in new markets.

Innovation is not limited to the innovation of products but also includes innovation of the very way a company engages in business. Innovation is considered as an incremental process, and while companies have been successful by adopting this approach, rapid changes in technology, economic, and social environments—have caused the approach to become less efficient in achieving competitive advantage. For example, the utility industry is facing economic, regulatory, environment challenges, consumer concerns and even the introduction of substitutes (energy storage solutions), highlighting that the traditional, vertical integrated utility model is no longer sustainable. Types of innovative business models are listed below.

Environmental Impact

- Social and consumer pressures are motivating organizations to produce products using recycled material.
- Changes in technology facilitate the shift from physical to virtual: replacing brick and mortar infrastructure with virtual services.
- Improvements in information systems facilitate production based on the demand model, where firms produce only when consumer demand has been quantified and confirmed.

Social Innovation

- Cooperative Ownership: owned and managed by members who consider the broader concerns of stakeholders, such as environmental and social concerns.
- Inclusive Sourcing: This is a key pillar of sustainable procurement and a competitive advantage, as it supports the company by providing the product, not just the volume of the product sourced.

Base of the Pyramid

- Differential Pricing: a method of setting prices based on consumers ability to pay, hence firms subsidize those who cannot pay higher prices.
- Microfinance: also called microcredit, providing access to financial services to low income individuals who would otherwise not have access to finance.
- Micro-Franchise: is a business model based on traditional franchising but focuses on creating business opportunities for the poor.

Financing Innovation

- Crowdfunding: is a method of raising funds for a project from a large number of people
- Freemium: a business model that offers the basic product or services free of charge but charging a premium for advanced features.
- Innovative Product Financing: a business model that gives consumers the option to lease or rent an item that they can’t afford or don’t want to buy outright.
- Subscription: a business model in which customers pay a recurring fee (monthly or annually) to gain ongoing access to a product or service.

Diverse Impact

- Behavior Change: are theories that business models can use to modify consumers behavior.
- Product as a Service: a business model that offers consumers the service a product provides rather than the product itself.
- Shared Resource: a business model that allows customers to access a product or service as needed, rather than own it.

The Disruption Process

Even if a product is inexpensive or targets non-consumers of existing technologies does not mean it is disruptive. The conditions necessary for a product to be disruptive are the following:

1. It must start out as inferior in terms of the performance that existing customers expect, but superior in price. As a result, existing customers will initially ignore it, but other customers (usually non-consumers of the incumbent products) will be attracted by its low price.
2. It must evolve to become “good enough” in performance (attracting mainstream customers from the earlier generation of incumbent products) while at the same time remaining superior in price.

What makes a product disruptive is how it develops over time and how incumbents respond to it. This has the important implication that you can never tell ex ante whether a product will be disruptive or not. To consider the potential of emerging-market innovations to be disruptive in more developed economies, we must first answer the following two questions:

1. Will the emerging-market innovators continue to have a significant price advantage over competitors from more developed countries?
2. Will the emerging-market innovators succeed in closing the performance gap so customers in advanced economies view their products as “good enough”?

These are obviously hypothetical questions, but we can begin to understand the factors that determine their answers by examining the success (or failure) of other disruptions originating in Western markets. For example:

- The razor business, Bic emerged as a huge, low-cost disruption to Gillette in the 1970s and quickly succeeded in capturing 25% of the disposable razor market by the early 1980s. Yet Gillette countered with its own line of inexpensive disposable razors, and Bic ceased being a major threat to Gillette in razors by the early 1990s.
- No-frills (low-cost) airlines disrupted and continue to disrupt traditional airlines quite successfully.

S9.5.5 Building a Culture of Innovation: The Role of Leadership

Culture is an important driver of innovation in organizations. It can either help facilitate innovation or inhibit it. Research has continually identified and emphasized the role of Leadership in creating a culture that supports and promotes innovation and at all levels. According to Hunter and Cushenbery (2011), leadership can play both a direct and indirect (see figure 5.2) influence on the culture within the organization. These influences are discussed below.

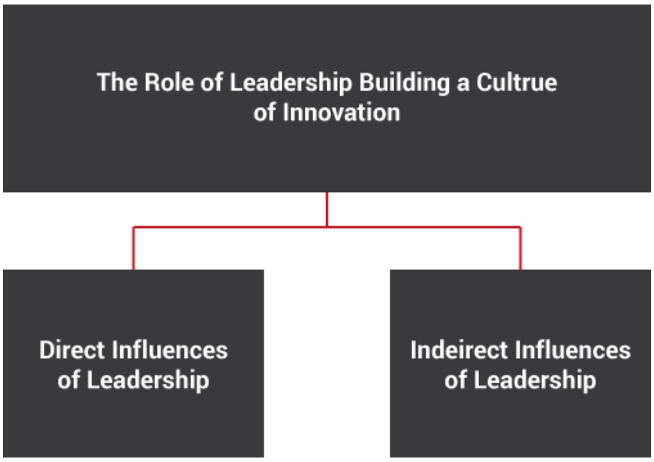


Figure 5.2: Leadership

Direct Influences of Leadership

Compulsory Reading

While the role of leaders can often be to facilitate innovation within the organization, it does not mean that they need to take a back seat and not actively provide input into the innovation process. There are several opportunities for leaders to direct and shape the innovation process in an organization, including:

- **Making Active Creative Contributions** – Many leaders have a strong creative talent and urge and are actively engaged in having creative inputs and suggestions to the innovation process. Leaders with high levels of creativity are often self-starters who quickly develop a high degree of comfort and skill in leading new ventures. Their skills also make them good at guiding others through the innovation process. Creative and innovative ventures at Apple for instance were frequently shaped by Steve Jobs through his creative instincts. However, it is also important for leaders not to control the innovation process too much. This could inhibit others in the organization from sharing their own creative inputs and challenging the ideas suggested by the leader.

- **Setting a Clear Vision and Strategy** – The clarity of the vision and direction set by leadership can often help influence the innovation process. Leaders who are skilled at setting the desired outcomes of the innovation process up-front, experience better innovation outputs. It follows the simple principle – the more clearly you define the problem, the better your chances are at succeeding in achieving the result. There is also evidence that indicates that while leaders need to have a clear vision, they also need to have enough flexibility to adapt their vision as the innovation process proceeds. Innovative ideas often evolve over time and it is important for leaders to be able to remain open to emergent proposals and seize them as they present themselves.

- **Resource Allocation** – One of the clearest indicators of the key priorities for leadership are derived through an analysis of where and how they allocate their resources. Leaders need to back their commitments to innovation with resourcing and funding. This is especially true during times when the economy is in a state of flux. Recent research on innovation trends during the global recession period found that companies that continued investing in innovation despite the recession and financial risks, made a better recovery post the recession.

  Realistically speaking, this can be quite a risky and confronting issue for leaders – because after all, their primary focus should be on maintaining a stable bottom line. The key here is to be critical in selecting the areas of innovation and being selective about where the investment goes. It may involve cutting down from six projects to turn the focus on one or two projects which show the highest promise and potential. This reduces the risk and the investment while not shunting the innovation process completely.

- **Decision Making** – In most organizations, the leaders have the final say on what gets implemented and what doesn't, what gets to the market and what gets held back and so on. Leaders in organizations often play the role of the film editor – making the necessary cuts and stitching the final story together. Thus, decision making is a key way in which leaders influence the innovation process. One of the important skills required for good decision making in this regard is being able to look ahead and imagine the possibilities and anticipate market trends. There is no one formula here and leaders develop this capability through their own experience and creative instincts.

Indirect Influences of Leadership

Leadership behaviors often influence the culture and environment of the organization – which is critical for fostering innovation and creativity. Their unconscious behaviors often have a significant impact on creating a culture of innovation. There are several ways in which leaders can indirectly influence and shape the innovation and creative potential of organizations, including:

Compulsory Reading

- **Role Modelling** – The age-old "lead by example" holds true for fostering innovation. As human beings, we learn by example and so by selecting a role model, we compare and replicate their behaviors accordingly to receive similar outcomes for ourselves.

  In organizations, the leader is often the role model, with their position of authority seemingly the ideal candidate on how to behave, what is acceptable and what isn't. Interestingly, studies have found that people have a strong affinity to select risk-taking leaders as their role models, who challenge our assumptions and broaden our perspective. A risk-taking leader encourages people in organizations to think more laterally and more creatively about possibilities. Google's founders and then CEOs for example, were often found to be hopping around the Googleplex wearing jump shoes and capes while conversing with employees.

- **Rewards and Recognition** – People pay attention to what leaders' value, reward and recognize, which we replicate when we see rewards and recognition but also avoid when it leads to unpleasant consequences. It is common practice for leaders to recognize successful innovations and celebrate them. However, encouraging innovation and creativity and establishing an environment that fosters the same requires leaders to go beyond recognizing successes to recognizing failures as well. This is because failure is an integral part of innovation, which statistics can show is about 95% of the time (19 out of 20 often fail). Some of the most famous quotes of innovation are, "*I have not failed. I've just found 10,000 ways that won't work."— Thomas Edison* or more recently "*The way to succeed is to double your failure rate." — IBM founder Thomas J. Watson, Sr*. So, rewarding and recognizing must be on valid attempts (both success and failures) for innovation, which can prevent risk aversion behavior and not thinking left field. Some innovations may also become successful in the future and so leaders must maintain a long-term perspective on innovation and recognize potential ideas with future value.

- **Hiring and Composition -** One of the key ways leaders indirectly impact innovation within the organization depends on their ability to select and hire the right skills and mix of expertise.

  This creates a bit of a dilemma for leaders, as things change so rapidly, with the current rate of progress, that it becomes difficult to anticipate and plan for the necessary skills that may be required for a hypothetical future product or innovation. So sometimes, it is necessary to hire certain skills and potentials before there is an explicit role for them to play, which can be based in instinct and risk appetites of leaders. This can result in quite significant pay-offs. For example, Google is known to have hired a team of voice recognition software engineers without quite knowing how to utilize them. But when the market presented the opportunity of voice recognition software being used in smartphones, Google was ready to capitalize and dominate the market. Leaders also need to be mindful of the mix or balance of skills within their teams.

  While diversity encourages creative thinking, a too diverse team is counter-productive and has diminishing results. While too many members in an innovation team can inhibit them from successfully tapping into the opinions and outputs of other diversities.

- **Establishing a Creative Environment** – Our environment has a huge impact on how we work and what we do, so it becomes important for leaders to create a supportive environment that encourages lateral thinking and inspires creativity. Giving people the autonomy to shape the physical environment they work in and personalize it to what works for them is a great way to encourage creativity and innovation. Some offices allow employees to decorate their working space however they want. Even a simple shift in the physical working environment like moving to an open plan office can encourage more opportunities for collaborating on innovative projects, give employees better access to leaders and creative role models and even offer better chances of identifying and capitalizing on a great idea shared in passing. Leaders can also influence the psychological working environment by giving more latitude to employees on how they approach their own work. For instance, Google and 3M give their employees a proportion of their time at work to do whatever they want, and the result for employees is amazing. Google's practice of allowing employees up to one day a week for pursuing their creative interests have seen the rise of innovative products and applications being developed – like Gmail!

Innovation is not a quick-fix solution to the problems of an organization. While it is true that organizations need to innovate to remain current and profitable, building an innovation process requires time, commitment and incremental shifts in the culture. Leaders need to be genuine in their attempts at driving innovation at all levels and be conscious of how their own behaviors and actions shape and influence innovation.

S9.5.6 What Makes a Leader

It is often thought that intelligence, toughness, determination and vision are core characteristics that define a successful leader and entrepreneur. Daniel Goleman (1998), who first brought the term "emotional intelligence," would disagree and instead propose additional characteristics (emotional intelligence) are needed to be successful. Emotional intelligence, which includes self-awareness, self-recognition, motivation, empathy and social skill (see Table 5.3), which may sound "soft" and unbusinesslike, was found by Goleman to enhance business results. He also found that emotional intelligence is a needed factor to enhance performance and that it is fortunate that emotional intelligence can be learned.

	Definition	Hallmarks
Decision	The ability to recognize and understand moods, emotions, and drives, as well as their effect on others.	Realistic self-assessment and evaluation.
Self-regulation	The ability to control one's behavior, thoughts and emotions before acting.	Dependability and integrity Comfort with uncertainty Open to change
Motivation	A passion to work for motives that go beyond money or status A tendency to pursue goals with passion, energy and persistence.	Strong stimulus to achieve Optimism, even under the possibility of failure Organizational responsibility
Empathy	The ability to recognize the emotional makeup of other people Skill in handling people according to their emotional reactions.	Expertise in building and retaining talent Cross-cultural sensitivity Service to clients and customers
Social skill	Proficiency in managing relationships and building networks An ability to find common ground and build rapport	Effectiveness in leading change Persuasiveness Expertise in building and leading teams

Table 5.3: Emotional Intelligence
Extracted from: Daniel Coleman (1998)

Other Studies on Emotional Intelligence

The literature has highlighted that Emotional Intelligence is a useful concept for organizational effectiveness (Cheniss & Coleman, 2001) and leadership (Reego et al, 2007). Another study conducted by Gross and Travaglione (2007) found that entrepreneurs will obtain a competitive advantage that sets their business performance apart from their competitors if they are able to enhance the ability to identify, understand and manage the emotional responses of themselves and others. A more recent study highlighted that emotional intelligence helps entrepreneurs to be good leaders and to motivate and inspire their employees to be innovative and creative in the organization, and therefore enhance performance (Ngah et al., 2016).

S9.5.7 The GLOBE Study

The Global Leadership & Organizational Behavior Effectiveness (GLOBE) Project is an organization dedicated to the study of culture and organizational effectiveness. The organization is led by Led by Prof. Robert J. House, U. of Pennsylvania (The Wharton School of Management). There are 170 researchers in 62 countries, covering three industry sectors: Finance, telecommunications, food processing.

GLOBE designed a questionnaire with 112 leader attributes and behaviors items which comprised of a wide variety of traits, skills, behaviors, and abilities potentially relevant to leadership emergence and effectiveness (The GLOBE 2004). Table 5.4 outlines the key six styles of global leadership dimensions that are the most significant on leadership effectiveness.

Charismatic / Value-Based Leadership	Displays the ability to inspire, motivate, and expect high performance outcomes from others based on firmly held core values. It includes the following six primary leadership dimensions: (a) visionary, (b) inspirational, (c) self-sacrifice, (d) integrity, (e) decisive and (f) performance oriented.
Team-Oriented Leadership	Emphasizes effective team building and implementation of a common purpose or goal among team members. It includes the following five primary leadership dimensions: (a) collaborative team orientation, (b) team integrator, (c) diplomatic, (d) malevolent (reverse scored), and (e) administratively competent.
Participative Leadership	Reflects the degree to which managers involve others in making and implementing decisions. It includes two primary leadership dimensions labelled (a) nonparticipative and (b) autocratic (both reverses scored).

Human-Oriented Leadership	Reflects supportive and considerate leadership and includes compassion and generosity. This leadership dimension includes two primary leadership dimensions labelled (a) modesty and (b) humane orientation.
Autonomous Leadership	Refers to independent and individualistic leadership attributes. It is measured by a single primary leadership dimension labelled autonomous leadership, consisting of individualistic, independence, autonomous, and unique attributes.
Self-Protective Leadership	Focuses on ensuring the safety and security of the individual and group through status enhancement and face saving. It includes five primary leadership dimensions labelled (a) self-centered, (b) status conscious, (c) conflict inducer, (d) face saver, and (e) procedural.

Table 5.4: The Globe Study — Leader Effectiveness and culture dimensions
Source: House et al., Culture, Leadership, and Organizations: The GLOBE Study of 62 Societies, Sage Publications, 2004

Conclusion

Entrepreneurship involves developing a new venture outside an existing organization whilst intrapreneurs also known as corporate entrepreneurship refers to employee initiatives within an existing organization to exploit new opportunity or create economic value without being asked to do so. There is evidence that intrapreneurship helps managers to renew and revitalize their business, to innovate, and to enhance the organization's overall performance (Antoncic and Hisrich 2001). Intrapreneurship is an important element in organizational, economic and social development.

Collaboration networks have the potential of bringing benefits to the involved parties and show a high potential as drivers of value creation. For instance, Noran (2009) highlighted that collaborative networks enhance the preparedness of their participants to promptly form virtual organizations that can successfully tender for large scale and distributed projects.

Reflection Questions
Q1) List and explain the different types of collaborations.
Q2) Explain the differences between entrepreneurship and intrapreneurship.
Q3) Listed some problem-solving skills that entrepreneurs require to be successful.
Q4) Define and explain what the types of collaborations are.

S9.6 Evaluating Entrepreneurial Start-Ups

Introduction

Entrepreneurship start-ups stimulate the economy by identifying new opportunities and redirecting resources to them. Neck et al. (2017) defines a start up as a temporary organization in pursuit of stablishing a strong business model. They typically begin by an entrepreneur that identified a problem and found a way to solve a problem. One of the first steps an entrepreneur(s) needs to take to start-up a company is to search for a repeatable and scalable business model that meet a marketplace need or problem. This includes intellectual property research and management, market research and regardless whether the entrepreneur is starting up a for-profit firm with the aim to maximize profits or a non-profit with the aim to maximize output levels, it is important to have a good understanding of the key revenue and cost drivers and to develop a plan that is financially sustainable in the short and long run.

S9.6.1 Intellectual Property

IP Protection

Intellectual Property is important for the success of any organization in today's knowledge economy. Intellectual Property (IP) describes intangible personal property created by human intelligence, such as inventions, slogans, logos, and processes. IP can occur in various forms, including: an invention, brand, design or artistic creation. There are various types of IP available, including:

- Your invention
- Your original design
- Your secret recipe
- Your brand
- Your point of difference from your competitors.

Intellectual property rights legally safeguard inventors for a certain period. Therefore, protecting and managing the organization's IP assets is crucial when launching your presence in the market. If not protected, it can be the difference between success or failure. Some forms of IP require a formal application and examination process before a right can be registered. Other rights come into play without the need for a registration process. Figure 6.1 outline the different types of IP rights and Table 6.1 provides a description of each.

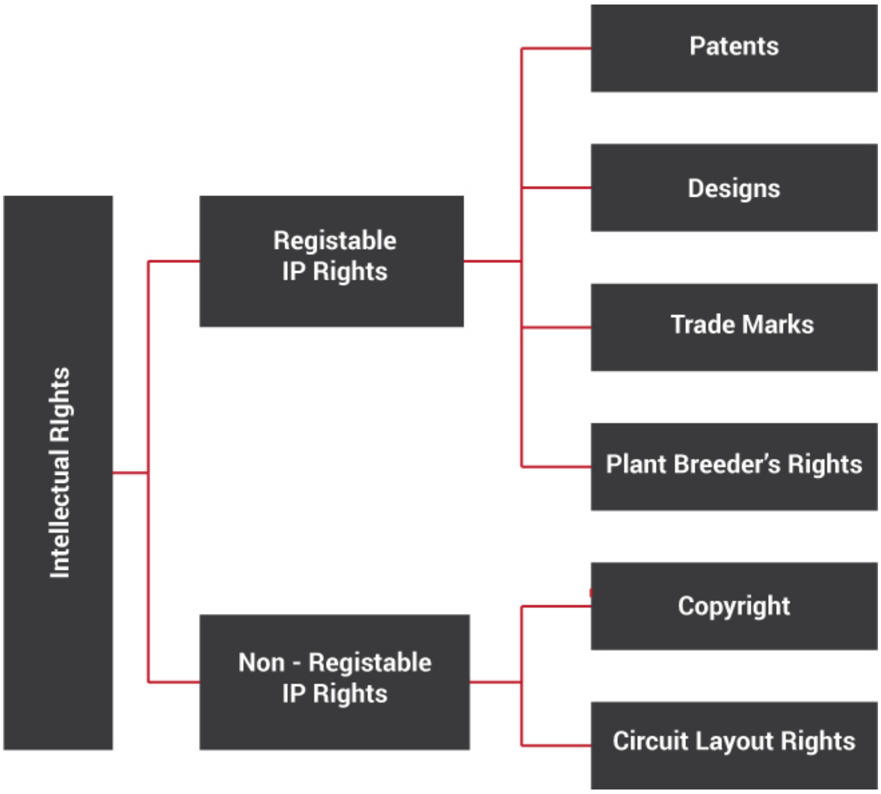


Figure 6.1 Types of Intellectual Property Rights

What's protected	Type of IP Protection	What it means	Example
Product designs The visual appearance of a product is protected, but not the way it works.	Registered design	A design refers to the features of shape, configuration, pattern or ornamentation which give a product a unique appearance and must be new and distinctive.	iPod, iPhone Kitchen appliances Footwear Fashion items
Logos, words letters, numbers, colors, **a phrase, sound, scent, shape, picture, aspect of packaging or branding - or any combination of these**	Trade mark	A trade is used to distinguish your goods and services from those of another business.	Qantas—Kangaroo symbol Chanel interlocked C's The McDonald's Golden Arches "Happy Little Vegemite's Tune
Inventions and new processes	Patent	A patent is a right that is granted for any device, process, method or substance process that is new, inventive and useful.	Quanta, Anti cervical cancer drug, Gardasil

Drawings, art, literature, music, film, broadcasts, computer programs	Copyright	The owner's original expression of ideas, but not the ideas or concepts themselves.	Annual reports Games of Thrones Sound recordings TV series Business proposals
Trade secrets and confidential information	Other	These types of IP rights give creators certain rights and privileges depending on the type of IP protection.	Coca Cola has used trade secrets to keep its formula from becoming public for decades.
New plant variety	Plant Breeder's Rights	Plant Breeder's rights (PBR) are exclusive commercial rights for registered plant varieties	Cotton plants with insect resistance and the pink iceberg rose

Table 6.1 Intellectual Property Rights Summary

Extracted from: Extracted from IP Australia, Australian Government, Retrieved, https://www.ipaustralia.gov.au/understanding-ip/getting-started-ip/types-of-ip

Compulsory Reading

The following concepts outline IP protection:

Intellectual Property (IP)

- IP ownership rights are the same as physical property.
- Protect and manage your IP (contractual arrangements) to benefit the most out of your idea/invention.

Value of IP rights

IP rights encourage and reward innovation. They provide the owner with the opportunity to take advantage of their creation while restricting competitors for a set period.

Success or failure

Protecting and managing the organization's IP is important when starting a product or service in the market—failure to do so may compromise the organization's success.

IP Rights Reward and Encourage

- Inspire owners to participate in innovative activities that benefit society
- Protect and reward the innovator's creative effort and skills
- Promote wider access to innovations and promote research and development which ultimately benefits society.
- Protection from competition for a set period of protection

IP rights provide competitive advantage

- IP rights can be a valuable bargaining tool, can be sold for financial gain and can become valuable assets.
- IP rights provides businesses with a competitive advantage over their competitors.
- IP laws give the innovator the right to control who can use the IP and how it can be used.
- Registered IP rights give the owner the right (but not the obligation) to invest in, sell or license an innovation over a certain period.

IP rights can be used repetitively without diminishing, which distinguishes it from physical assets. That means, for example, that the same IP can be licensed to several different licensees each based on a specified geographic region. IP laws provide the investor an opportunity to make a profit by protecting the new products and/or services from being replicated by a competitor (IP Australia).

S9.6.2 Your IP Strategy

Protecting your IP is a critical component of a successful business strategy. An intellectual property strategy should be carefully designed to the needs of your company. The entrepreneur needs to think carefully about the industry and the market in which they are operating or would like to enter, this includes managing risk and financial matters. Listed below are some of the key issues to consider when designing the IP strategy from IP Australia:

Compulsory Reading

- **Identify your IP**
  You may have a wealth of IP, from the name on your door to a new innovative process - these will be things that help differentiate you from your competitors. As your business grows, so too will the importance of these intangible assets.

- **Legal measures**
  Go to the Australian IP website and carry out a patent and trade mark search to be certain that your trade mark or patent application will not infringe any existing rights held by other parties or to determine the novelty of your invention.

- **Understand your options**
  Do your research and enhance your knowledge on the different types of IP and the advantages of each one (See Table 6.5 as a starting point). Patents protect inventions; design registration protects their look .

- **Organizational measure—Keep it confidential**
  There is nothing more important than keeping your idea confidential until it is protected. If talking to others about your idea, use a confidentiality agreement to prevent them from disclosing your idea without permission. An IP Professional can prepare a confidentiality agreement for you.

- **Protect your idea or brand by registering it**
  Remember a business name does not give you property rights for the use of trading and does protect your idea. Use the IP system to register a patent, trade mark, design or plant breeder's right.

- **Be cautious in commercialization**
  Before you begin any negotiation, build a model of your invention to help prospective financial backers visualize your smart idea and its market potential. However, do not let anyone see it without having a confidentiality agreement in place first. Also, if you have an invention, be cautious not to look for funding in relation to that invention before lodging an application for patent protection, as it may prevent you from receiving a patent.

- **Track your costs**
  Record all cost for your invention to help you put a value on the IP and to measure the profitability.

- **Research your market**
  Research your potential market and understand the likely consumers, buyers, licensees, investors, manufacturers and distributors. This will help you work out your unit cost and should give you a basis to see if your product or service is competitive. It will also assist you to avoid infringing the IP rights of others.

- **Enhance your business know-how**
  To successfully commercialize your idea, you need a variety of business skills. Enhance your knowledge by attending support groups such as inventors' associations and government agencies for assistance. However, before taking major steps, invest in quality professional advice.

- **Work out a commercialization strategy**
  Seek professional advice before entering into contractual agreements with manufacturers to make sure it is profitable to manufacture. There are different ways to make a profit from IP, including selling it, license it or make products yourself.

- **Beware of infringement**
  Keep an eye out for firms copying your IP and stealing your market share or even ruining your brand's reputation. Seek professional advice to help you decide on the best course of action against infringers. You may need to take legal action, but infringers can often be stopped without having to go that far.

S9.6.3 Market Research

Market research is an important part of designing your marketing strategy. It's about collecting information to give you an insight into your customers' mind so that you understand what they want, how they gather information and where they come from. You can also do market research to get a better idea of market trends and what is happening in your industry sector.

The information you gather and analyze builds the foundation of good business decisions whether it's deciding what product or service you'll offer, where your business should be located, how to distribute your products or how you communicate with consumers.

Market research is important for every business and should not be just a one-off activity, as it is an ongoing process at every phase of the business. Market research provides the information necessary to understand the business, the market and can enhance the firm's success. Listed below are reasons business owners conduct research.

Compulsory Reading

- **Identify potential customers**
  Who is going to use your product/service? How old are they? Are they male or female? Are they married, single or divorced? Do they have children? Where do they live? and so on.

- **Understanding your existing customers**
  Why do customers choose your product over competitors? What do they value? Is it service, product quality or the prestige associated with consuming your product/service? Who influences their buying decision? What magazines do they read? What websites do they visit? What do they enjoy doing?

- **Set realistic targets**
  From the information you collect you'll be able to set realistic targets for areas such as growth, sales and the introduction of new products/services.

- **Develop effective strategies**
  From your research you'll be able to develop effective strategies regarding all marketing decisions about how to price your product/service, how to distribute your product/service, which media channels to use.

- **Examine and solve business problems**
  If you've identified a business problem, research will help you work out what is happening. For example, if profits have fallen, by conducting market research you will be able to identify the cause—it could be a decline in economic conditions, a new competitor, an increase in product defects, or bad customer service. Only by identifying the cause can you find a solution.

- **Prepare for business expansion**
  Market research will help you gather all the information necessary to identify possible areas for expansion. For example, you could be looking to expand your fitness center and you need to find the right location to attract the most customers.

- **Identify business opportunities.**
  Your research could identify new business opportunities. You may find an un-serviced or under-serviced market. You could identify changes in the macro or micro economic conditions that can result in an increase in demand for a good or service.

Set your research objectives

The scope of your research is determined by what you want to achieve (your objectives) and the types of decisions it needs to help you make.
Before you get started it is essential to define your objectives. This is the most important part of the process and will avoid wasting time and effort in later stages.

Ask yourself these three questions:

- What is the purpose of the research?
- What information do I need?
- How will the information be used?

Four stages of research study

Conducting a successful research study involves four separate stages:

1. Checking if the same or similar research has been carried out in the past;
2. Reviewing any existing relevant data;
3. Determining when the information is needed and how much you can spend to obtain it; and
4. Deciding how the data will be used, and by whom.

If your research will help you to make a significant decision (for example, introducing a new product or starting a business), then it's a good idea to think about employing a professional market research organization or consultant. A research expert will have the knowledge and experience to get information which is reliable. If the cost is prohibitive you should buy at least a few hours of professional research time to get advice in conducting your own market research. This could help you avoid obtaining flawed data which will produce misleading and potentially costly conclusions.

Find out what informational already exists

There are two types of data; primary and secondary. Existing information (for example census statistics) is known as secondary data and primary is the collection of new data.

Primary data research

- Observation
- Personal interview

Secondary data research

- Official
- Non-official

Compulsory Reading

1. **Primary data research**
   Primary data is the information you collect by conducting specialized surveys, focus groups or interviews. Some of the advantages of primary data include greater control, source is known, real time data, more flexibility, secrecy can be maintained, and it can answer a specific question. Primary data also has its disadvantages: time consuming, often expensive and potentially riskier if the data is not collected correctly. To ensure that the data collected is fit for purpose, it is important to take time to define the objectives and understand the problem you are researching.

   For example, you may want to increase market share by improving the product. This may involve surveys and interviews to identify key features that customers want in their product. Once you collect all the information, your team can start the process of product improvement and then you can follow it up with focus group studies to test your product before starting the marketing campaign. It is important to note that while primary data is useful, it should not be used in isolation—a good strategy is to use both primary and secondary data in decision making. For example, price decisions also need to consider economic and market conditions (Secondary data). Therefore, by considering the macro-environment you will be making informed decisions and increase your chances of increasing market share.

Listed below are the two types of Surveys, which can be categorized as either observation or interview:

- ***Observation***
  Conducting a survey via observation involves activities such as visiting competitors to see how they perform, the image they are trying to convey as well as the products they stock and the prices they charge. Observational surveys also include listening to what others say about your competitors. The internet can be used here as it provides a platform that can be used to study competitors, for example looking at their website.

- ***Personal interview***
  A personal interview involves interviewing several customers for obtaining qualitative and quantitative information. Qualitative information includes looking at the customers' attitudes towards companies, products, services and other issues. For example, the aim might be to find out why people purchase the business' products and if their advertisements are effective. This information could be used to help future planning of techniques, promotional activities and even sales presentations. Quantitative information can be useful in predicting future earnings and profits and is obtained through interviewing a number of people to find out information such as how many will be likely to purchase a new product entering the market.

Surveys involving personal interviews include:

- Face-to-face surveys
- Group interviews (focus groups)
- Mail surveys
- Online surveys
- Survey samples.

After the type of survey is decided, the sample of respondents need to be considered. The sample could be a selection of people from categories such as industry, area, sex, age or income groups or they could be randomly selected to represent the “unidentified population”. This is followed by choosing the sample size the survey requires. As a rule of thumb, the sample size for a small area, metropolitan area and a village area is 100-200, 400-500 and 600-1000, respectively. Following such a rule should produce a reliable result. The smaller the sample sized used, the greater the possibility of the results being an error, or it being misinterpreted.

2. **Secondary data research**
   A quicker and cheaper method is using secondary data. A lot of information is already stored and can be accessed in internal company records or official sources. Information that is collected on a day-to-day basis can be used to identify trends such as popular products or even the seasonality of product/service demand. Secondary information can also fall under two categories; Official and Non-official.

   - ***Official***
     Official secondary information is information gathered and published by Federal, State and Local government agencies. The largest source of official research in Australia is the Australian Bureau of Statistics (ABS), which has a collection of a wide range of data at a national and local level. Such data includes census, trade and industry dates as well as demographic statistics down to a suburb level and changes in social trends. Other sources include: Reserve Bank of Australia, Australian Prudential Regulation Authority, industry and trade publications, IBISWorld reports.

   - ***Non-official***
     Non-official data is data that can be obtained from sources such as the internet, reference books, trade directories and trade associations, magazines, newspapers, banks, technical colleges, universities, research institutions, and publications from market research organizations.

Analyze the results and make an informed decision

Once you have collected the surveys, analyze the output without judgements, keep an open mind and be objective. Information is power, and only by understanding this point, can you think clearly and make informed decisions. Outlined below are some golden rules when interpreting the findings of your market research:

- The better the research, the more informed the decisions.
- Were the questions designed correctly and are the results reliable?
- If the results are reliable, accept them and move forward.
- Be aware of your own biases, be open minded.
- Consider uncertainty and get more information.

Design an efficient data management system, keep records of all surveys and data for future use. Remember, the most successful organizations are always conducting market research and know the importance of data (primary or secondary) in decision making.

S9.6.4 Evaluating Revenue & Costs Framework

The goal of an organization is to maximize profit, which is equal to revenue minus cost. Economic agents have an objective that they are trying to optimize:

- Individuals assumed to maximize utility;
- For-profit firms maximize profits or minimize costs; and
- Not-for-profits may maximize output levels.

Entrepreneurs need to have a good understanding of what are the key drivers for their revenue sources and cost of providing the good or service.

Revenue Drivers

A revenue model is a framework for generating revenue (see Table 6.3). Models can vary based on the industry, product or service and competition. Entrepreneurs need to assess whether the revenue framework is sustainable and accepted by prospective investors. Neck et al. (2017, p.263) identified four main revenue drivers: customers, frequency, price and the selling process (see Figure 6.2)

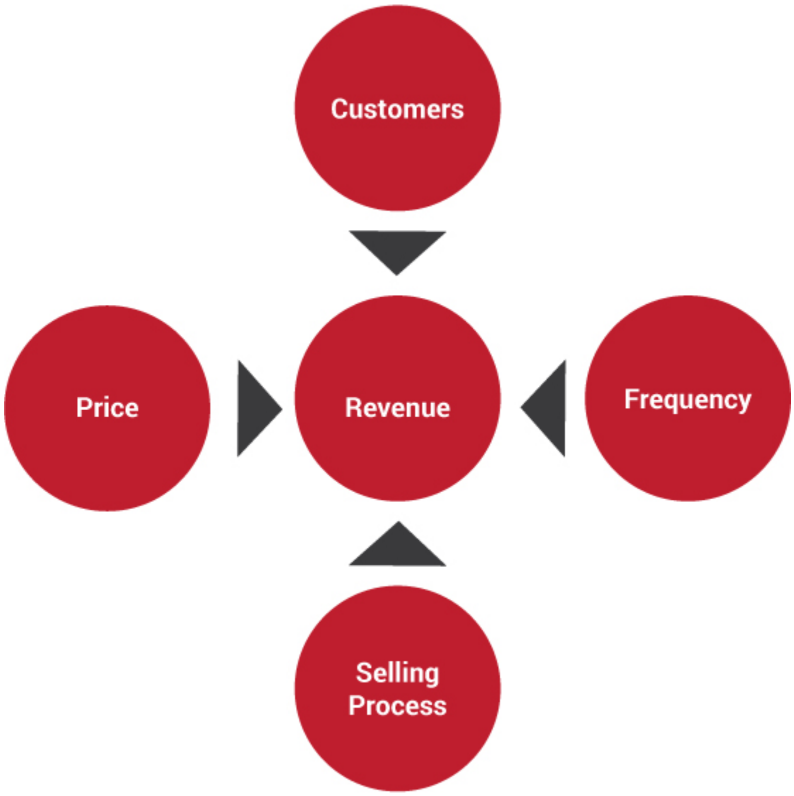


Figure 6.2: key Revenue Drivers.
Extracted from: Neck et al. (2017, p 263)

Compulsory Reading

Revenue models influence who your customers are and how you reach them. Listed in Table 6.2 are some of the key revenue variables that are useful in decision making.

Total Revenue	**Price X Quantity**
Average Revenue	$$AR = \frac{TR}{Q}$$ Where TR = Total Revenue and Q = quantity sold
Marginal Revenue	$$MR = \frac{\Delta MR}{\Delta Q}$$ Where ΔMR = Marginal Revenue (additional revenue that is generated by increasing sales by one unit), and Δ Q is the change in quantity sold

Table 6.2 Summary of Revenue Formulas The following table outlines some of the revenue models:

Ten Types of Revenue Models

Unit sales	The amount of revenue generated by the number of items (units) sold by the company.
Advertising	The amount of revenue gained through advertising products and services.
Data	The revenue generated by selling high-quality, exclusive, valuable information to other parties.
Intermediation	The amount of revenue generated by third parties.
Licensing	The amount of revenue generated by giving permission to other parties to use protected intellectual property (patents, copyrights, trademarks) in exchange for fees.
Franchising	The process whereby franchises are sold by an existing business to allow another party to trade under the name of that business.
Subscription	The amount of revenue generated by charging customers payment to gain continuous access to a product or service.
Professional	The amount of revenue generated by providing professional services on a time and materials contract.
Utility and Usage	The amount of revenue generated by charging customers fees based on how often goods or services are used.
Freemium	The amount of revenue gained by mixing free (mainly web-based) basic services with premium or upgraded services.

Table 6.3: Ten types of Revenue Models

Source Neck et al. (2017, p.258).

Cost Drivers

Perhaps the most difficult decision to make in developing pricing strategies is how to classify the wide variety of costs borne by seller and producers. Costs are importance in decision making, the standard accounting techniques are not suitable for making pricing or output decisions– we need to consider economic costs,

1. Explicit - actual spending on inputs
2. Implicit - opportunity costs (the loss of other alternative when one alternative is chosen)

Economic costs are equal to explicit and implicit costs. Even though implicit costs are technically not incurred and therefore recorded for accounting purposes, they are important costs to consider in making optimal economic and business decisions. Entrepreneurs also need to consider all costs, including 'Sunk Costs' (see Table 6.4). Cost can be broken down, even further into fixed and variable costs, which equal Total costs (Figure 6.3 and 6.4).

1. **Fixed costs:** Fixed costs are the costs associated with running businesses that must be paid regardless of the level of production; for example, rent or other overheads generally remain constant.

2. **Variable costs:** A variable cost is determined by the level of production and will vary accordantly to production levels. For example, labor and material costs will increase as production increases. Cost budgeting and analysis is important, particularly variable costs, since a high variable cost indicates that a business can continue to function at a relatively low revenue level. While, a high fixed cost requires that a business maintain a high revenue level to stay in business. Examples of variable costs:
    - Direct materials, since the cost of materials are charged according to production levels.
    - Labor costs, since wages are associated with billable hours to production expense or sales transactions.

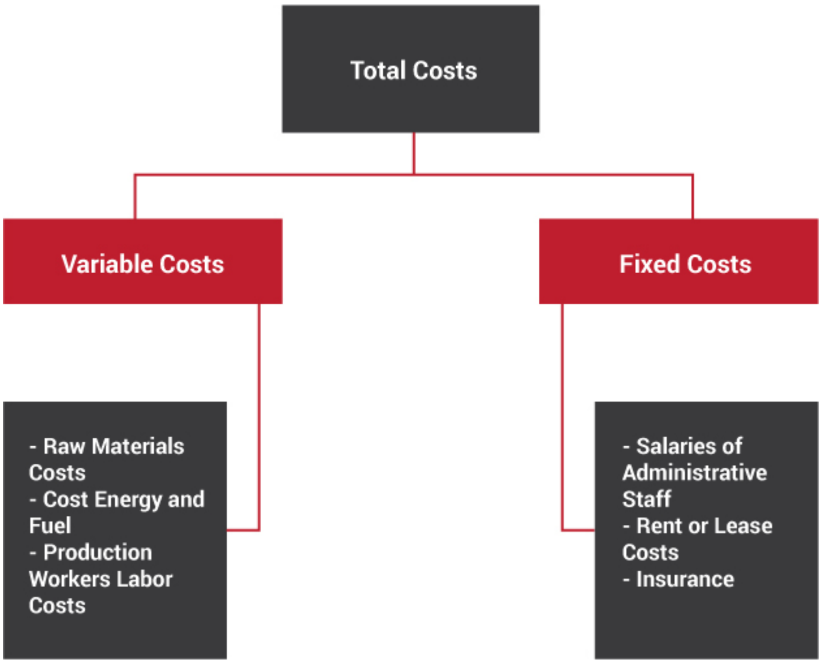


Figure 6.3: Components of Total Cost

Variable costs analysis is important in the short run, because they factor into profit projections and the calculation of break-even points for a business unit or projects. Costs vary depending on production and many cost items have both fixed and variable components. For example, supervisors and management salaries typically do not vary with the level of production. However, if sales fall and production is reduced, then layoffs may occur. This highlights that in the long run all costs are variable.

Not all firms exhibit similar cost structures, for example by comparing variable costs to fixed costs it may exhibit more consistent per-unit costs and therefore depict more predictable per-unit profit margins than a company with fewer variable costs. However, a company with fewer variable costs may amplify potential profits or losses, since revenue increases (or decreases) are applied to a more constant cost level. The Diagram below shows the total fixed and variable costs as sales increases.

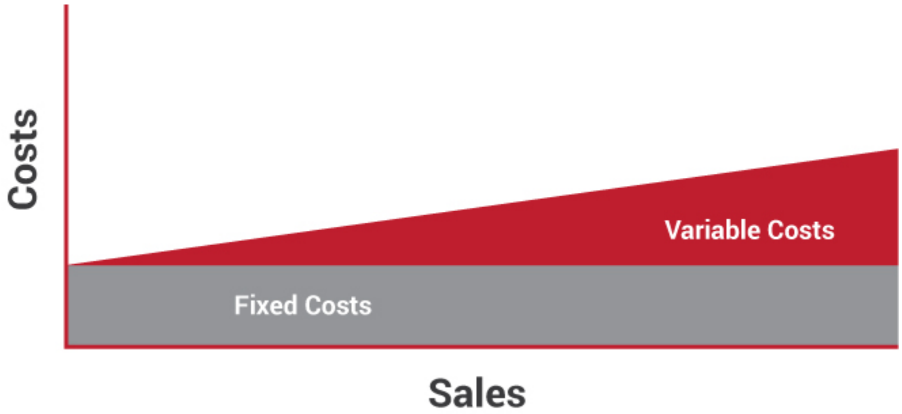


Figure 6.4: Fixed and Variable Cost

Compulsory Reading

Entrepreneurs need to have knowledge on what is driving costs (variable and fixed) and revenue, to make optimal decisions. This means making an educated forecast about how to respond given uncertain demand, operating and economic conditions.

Sunk Costs	**Description**
Staff Training and Education	A skilled staff can potentially increase the number of clients you attract, your level of customer service and employee confidence, and make employees more loyal to your company. Once you dedicate money to employee training and education, it becomes a sunk cost. The money is used to help employees learn a useful skill or information, taught in workshops or classes, that they can apply to the business. This cost and the time spent in training cannot be recovered.
Product Research	Companies spend money each year for research and development as they work to come up with new products and services to offer their customers, or as they try to refine existing products and services. While the nature of research varies from business to business, it's recognized as a sunk cost, since once the money is spent on conducting a focus group or administering a survey, it's gone.

Consultants	Whether you hire a marketing consultant or a specialist to help your business attract customers, there's a fee involved with the services provided. Once this money is spent, it becomes a sunk cost.
Advertising	From direct mail marketing to purchasing advertising placements through print and web media, small businesses use advertising to attract and retain customers. Money spent on advertising doesn't guarantee a return, but once the money is spent and the advertising effort runs, advertising expenditures are regarded as sunk costs.
Specialty Equipment	Businesses that own equipment that can be used by other businesses in the industry or by other businesses in general, have the option to sell their equipment, if they sell the business or need to upgrade. However, if you have specialty equipment made for your business, specially to create a product or service you offer exclusively, the purchase becomes a sunk cost.

Table 6.4: Example of Sunk Costs

Total Fixed Cost	TFC is the cost of the firm's fixed costs inputs, for example: Rent, will not change will the level of production; it is a cost that is fixed.
Total Variable Cost	TVC is the cost of the firm's variable inputs, which is determined on the level of production. For example: wages, raw materials.
Average Fixed Cost	$AFC = \frac{TFC}{Q}$ TFC = Total Fixed Cost, and Q = Quantity
Average Variable Cost	$AVC = \frac{TVC}{Q}$ TVC = Total Variable Cost, and Q = Quantity
Total Cost	$TC = TFC + TVC$
Average Total Cost	$ATC = \frac{TC}{Q}$
Marginal Cost	$MC = \frac{\Delta TC}{\Delta Q}$ Δ = Change in total costs, Δ Change in quantity produced

Table 6.5: Summary of Cost Formulas

S9.6.5 Business Plan

The business plan is a formal document, providing company background and financial information, that helps companies outline their goals, describes how they intend to reach them and the steps necessary to attain them. This is important because the better the business plan, the more attractive your start-up seems to investors (see Table 6.4)

1. Cover	
2. Table of Contents	
3. Executive summary (2-3 pages)	• Brief introduction & description of the opportunity • Company overview • Product or service description • Industry overview • Marketplace & target market • Competitive advantage • Business model (with summary of financials) • Management team • Offering
4. Company overview (1-2 pages)	• Company description • History & current status (stage of development) • Products & service description • Competitive advantages • Entry, growth, & exit strategies
5. Industry, Market, & Competitor Analysis (3-6 pages)	• Industry analysis • Marketplace analysis • Competitor analysis
6. Marketing Plan (1-4 pages)	• Target market strategy • Product/service strategy • Pricing strategy • Distribution strategy • Advertising and promotion strategy • Sales strategy • Market and sales Forecast • Marketing expenses
7. Operating plan (2 pages)	• Operations strategy • Scope of operations • Ongoing operations • Operation expenses
8. Development Plan (1-2 pages)	• Development strategy • Development timeline (milestone) • Development expenses
9. Management (1-2 pages)	• Company organization • Management team • Ownership & compensation • Administrative expenses

10. Critical risks (1-2 pages)	• Market, customer, financial risks • Competitor retaliation • Contingency plans
11. Offering (up to 1 page)	• Investment requirements • Offer
12. Financial Plan (up to 2 text pages, including financial statements)	• Detailed financial assumptions • Pro forma financial statements • Breakeven analysis and other calculations • Do include statement within this section, do not place statement on the appendix
13. Appendices (no maximum)	• Customer survey and results • Other items to include may be menus, product specifications, team resumes, sample promotions, product pictures.

Table 6.6: Example of Business Plan Outline (From your recommended Text)

Source: Neck et al. (2017, pp.239)

Conclusion

One of the first steps an entrepreneur(s) needs to take to start-up a company is to search for a repeatable and scalable business model that meets a marketplace need or problem. This includes protecting and managing the IP assets which is critical when establishing and entering a market, it is often the difference between success or failure. Conducing market research is a key part of developing your marketing strategy. The information you gather and analyze builds the foundation of good business decisions whether it's deciding what product or service you'll offer, where your business should be located, how to distribute your products or how you communicate with consumers.

Finally, regardless whether the entrepreneur is starting up a for-profit firm with the aim to maximize profits or a non-profit with the aim to maximize output levels, it is important to have a good understanding of the key revenue and cost drivers and to develop a plan that is financially sustainable in the short and long run.

Reflection Questions

Q1) What is the difference between registrable and non-registrable IP rights? Use examples.
Q2) Identify and explain the main revenue drivers?
Q3) What are the steps for preparing a business plan?

S9.7 Financing Decisions for Startups

Introduction

There are many types of financing options and routes available for entrepreneurs to start or grow their business, including personal savings or from family/friends, loans, angel investors, venture capital and loans. The entrepreneurship can use multiple sources to attract funds, but their abilities are the most important determinant to attract investors. The following sections will discuss some of the early stage funding options.

S9.7.1 Angel Investors

Angel investors are the type of investors who uses their money to fund young start up private businesses run by entrepreneurs who are neither friends nor family. Angel investors can be professionals such as former business associates, lawyers or entrepreneurs interested in helping other entrepreneurs. Their motive for sharing their knowledge and expertise, including to invest in your business is for a financial return and for a piece of the action.

Angel investors provide revenue and become important mentors that have the best interest for the firm to succeed, given their money is on the line. Angel investors help start-ups as well as established businesses, but they may require from 10 to 50 percent of your business. They provide financial and mentoring support, but if they feel the business could be run better, they might fire you from the company you created—however the benefits outweigh the risks. Figure 7.1 outlines the different types of Angel Investors.

Figure 7.1 Types of Angel Investors

Attracting Angel Investors

In the past, angel investors were wealthy people, veteran entrepreneurs, trusted bankers, lawyers or accountants who the business owner knew or who were discovered through old-fashioned networking. Listed below are ways of attracting angel investors:

Compulsory Reading

1. **The potential for a solid return.**
   While many Angels investors want to make a difference, they expect to get a higher return than they could get on the market and get their money back.

2. **A good motive to invest.**
   There are three categories of angel investors, and each have their own motive to invest: the economic investor—invest purely for financial gain; the hedonistic investor—is most attracted by the opportunity of creating something new; the altruistic investor may be most concerned about making

a difference by helping his community or attracted by the potential of developing environmental technologies. It is important to know your business and know who might be interested in investing in it and how you should approach them.

3. **A dynamic management team.**
   Having a solid management team provides evidence that the organization has knowledgeable people who know about finance, marketing, product development, managing people and hence the right skills to be successful—this is key in attracting an angel investor.

4. **A strong business plan.**
   Having a complete business plan is important for convincing an angel investor. They want to see the vision your company is trying to achieve and if you've given any thought on your plan to get there. Including things such as detailed marketing plans, financial projects and specifics about the market you are trying to target.

5. **A business structured for investment.**
   Some angel investors provide loans to businesses, however the preferred option, by more than half of angel investors, is a minority equity ownership position. This means that businesses must be structured to allow for investments and the relinquishment of certain amounts of ownership to attract angel investors.

6. **The opportunity to be actively involved.**
   For many angel investors, their investment is not about the money but about the ability to participate in developing the business. Such ability can involve acting as a mentor or even as an active role in managing the company. It can often involve angel investors having a seat on the business' board of directors.

7. **A viable exit strategy.**
   An exit strategy will be expected to be presented to an Angel investor before they invest in the business. A common exit strategy for angel investors (who hold equity ownership positions) involves selling shares to the company's principle and a common exit strategy for debt-holding investors is selling or merging their company. As such to attract an Angel investor, the business must ensure it is investor ready. The best way to attract an angel investor is to prepare a strong strategic business plan, including details of the skilled management team.

S9.7.2 Venture Capitalist

Compulsory Reading

Venture capitalists are the type of professional investors who generally invests in early-stage and emerging companies because of long-term growth potential. As in venture capital, a venture philanthropist takes an investment approach to determine the most appropriate financing for each organization and can operate across the spectrum of investment returns, depending on their own missions.

Figure 7.2 depicts the venture capital process. First, investors' funds flow into a company, generally during pre-IPO process, as an investment rather than a loan. The venture capitalist consists of an individual or small group, which manages the investment and ensures a high rate of return, including securing ownership position in the business.

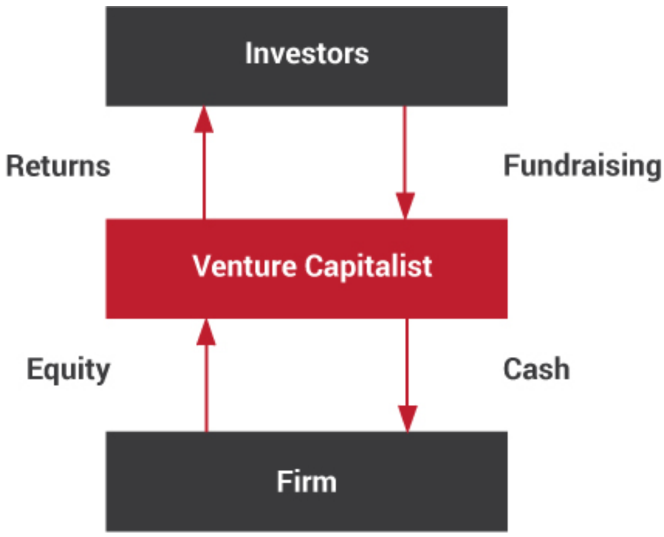


Figure 7.2: Venture Capital Process (Gompers and Lerner 1999)
Extracted from: Rasila (2004)

There are several types of venture capital:

- **Private venture capital partnerships** are looking for business that can generate an average of 30 percent return and can be considered the riskiest form of partnerships. Given that they have a large capital base $500 million, they want to be involved in the planning and management of the business.

- **Industrial venture capital pools** are looking for high-tech businesses using state-of-the-art technology that can provide a competitive advantage.

- **Investment banking firms** are looking for business looking to expand or at the early-stage of financing, they provide funding and sell the company's stock to equity investors.

Venture Capital

Venture capital can also include managerial and technical expertise. Most venture capital comes from a group of wealthy investors, investment banks and other financial institutions that pool such investments or partnerships. This method of raising capital is attractive for new ventures which cannot raise funds by issuing debt. The disadvantage is that the owner will lose some control over the decision making.

Philanthropist investors typically invest in companies with a short-term view that the company will be sold either to the public or to larger firms, and they will be able to get their investment back. Companies they will consider investing in usually have the following features:

- Rapid, steady sales growth
- A proprietary new technology or dominant position in an emerging market
- A sound management team
- The potential for being acquired by a larger company or taken public in a stock offering

The way to contact venture capitalists is through an introduction from another business owner, banker, attorney, or other professional who knows you and the venture capitalist well enough to approach them with the proposition.

Venture Capital Investment Process

The completion of a successful venture capital negotiation requires the deal to undertake a multistage process. Figure 7.3 outlines Klonowski's (2018) research on venture capital investment processes by academics in the mid-1990's.

Model 1 included five stages: deal generation, screening, evaluation, structuring and post-investment activities. Model 2 included 6 stages: origination; VC-firm specific screen; generic screen; first phase evaluation; second phase evaluation and closing. The Klonowski model proposes eight stages: (1) deal generation, (2) initial screening, (3) due diligence phase 1 and internal feedback, (4) pre-approval completions, (5) due diligence phase II and internal approvals, (6) deal completion, (7) monitoring, and finally (8) exit.

While there are many models for VCI processes, it is important for entrepreneurs to research for one that best suits their needs. The Klonowski model is the most comprehensive as it has incorporated extra features, including additional due diligence and monitoring process that venture capitalists must go through with their venture investors to complete the deal and exit.

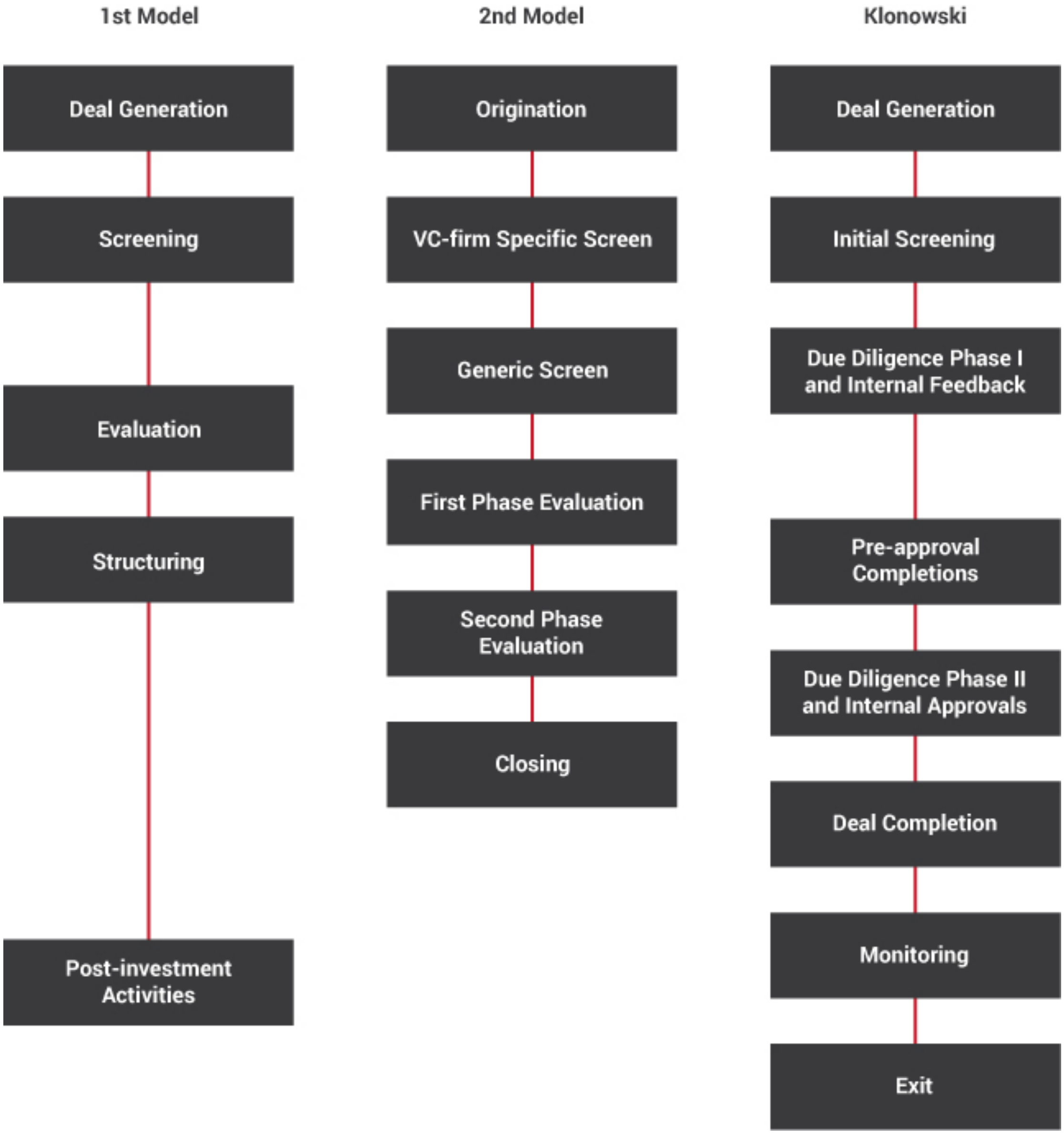


Figure 7.3 A comparison of various models of the venture capital investment process.
Extracted from: Klonowski (2018).

Venture Capital Stages

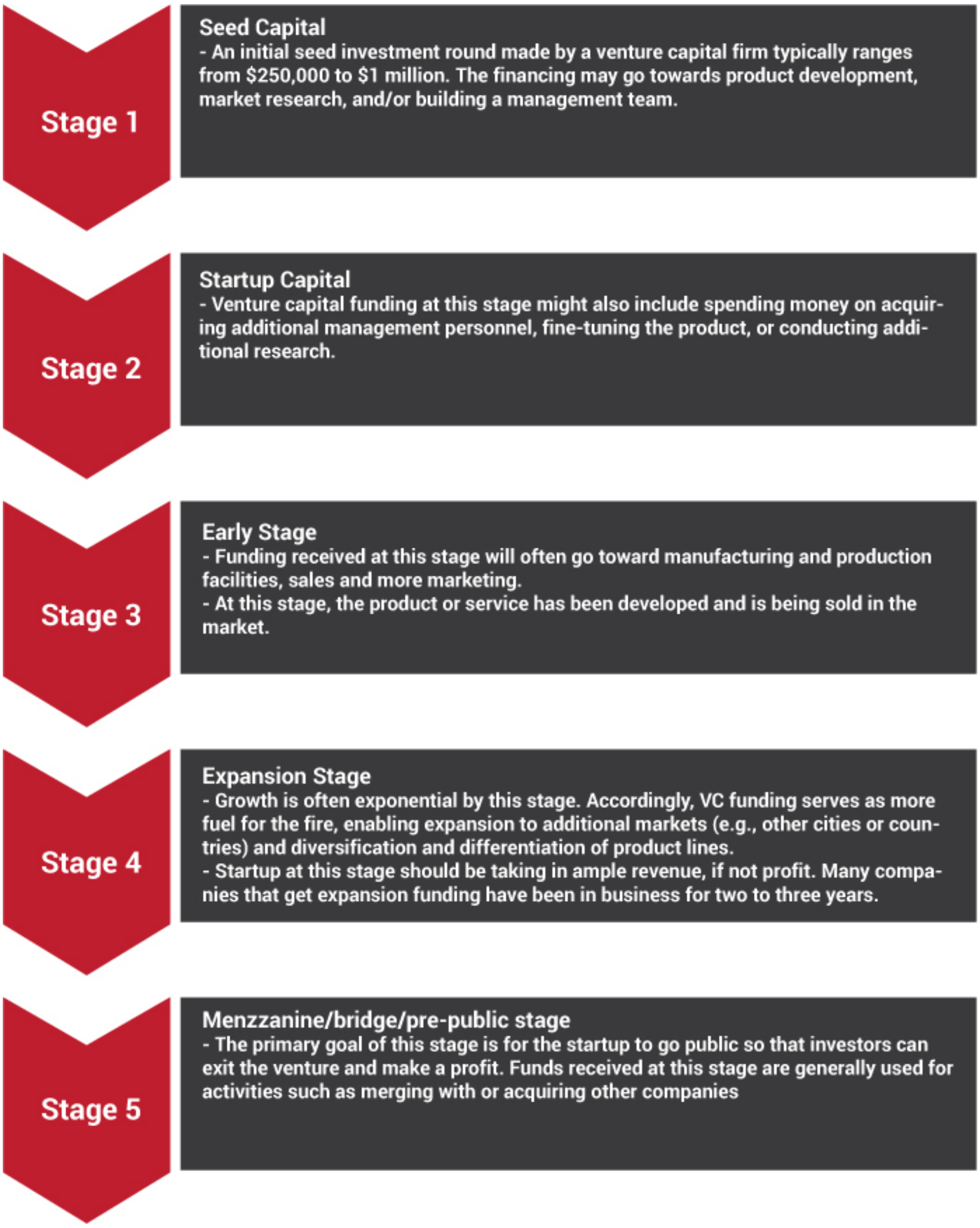


Figure 7.4 The stages in Venture Capital Investment

Advantages of venture capital

Venture capital has several advantages over other forms of finance. Table 7.1 outlines the advantages of venture capital

Finance	**The venture capitalist injects long-term equity finance, which provides a solid capital base for future growth. One advantage is that the venture capitalist can provide additional funding if required.**
Business Partner	The venture capitalist is a business partner, contributing financially but also sharing the risks and rewards. Venture capitalists gain a return if the business is a success.
Mentoring	One of the biggest advantages is the mentoring component; the business will have access to expert advice on strategic, operational and financial matters.
Alliances	The company can benefit from the venture capitalist network of contacts that can add value to the organization, for example: recruiting key personnel; introductions to strategic partners and, if additional funds are required, co-investments with other venture capital.
Facilitation of Exit	The venture capitalist has the knowledge in the process of preparing a company for an initial public offering and facilitating in trade sales.

Table 7.1 Advantages of venture capital

Extracted from: Australian Private Equity & Venture Capital Association Limited. Retrieved, https://www.avcal.com.au/looking-for-capital/how-to-get-venture-capital

S9.7.3 Government Grants

Government grant is a financial award given by the federal, state or local government to an eligible grantee. The Grants in Australian Research study (2018, p5) found that the Community Funding Centre database traced more than 3400 grants programs in Australia and estimated that around $80 billion dollars is given away each year, the bulk of it from government, with that figure rising each year. Government grants are a financial assistance that is not expected to be repaid and can come in a wide range of shapes and forms, including one off lump sum grants (non-repayable), expert advice or assistance programs or tax and duty subsidies.

Key Points about Grants:

- Grants are not restricted to any industry or sector as they are designed to help those in need of assistance.
- Even though most grants are awarded to government organizations at the state and local government level, non-profit organizations and academia, anyone can still apply for one.
- If the goods or services benefit the general public, the chance of getting a grant increases. For example, non-profit organizations have an advantage in receiving grants as their goals might align with the government's goals.
- Australian Institute of Grants Management website (see additional resources), provides useful information on how to apply and how the money can be used.
- Securing a grant is not an easy process, and the funding is not free money. The grant recipient has a duty of care and obligation to fulfil every requirement, and failure may result in legal penalties.

Compulsory Reading

Advantages of Grants:
Unlike loans, grants do not need to be repaid (good credit is not needed) and impose no interest or tax implications on the recipient. Additionally, grants also provide an enhanced level of exposure and creditability; therefore, organizations that wish to also raise money from other sources can use their approved grant to aid their private fundraising efforts.

While there is no rule on the number grant applications in a given year, in some cases businesses may need to fund their projects before the government provides reimbursement of the expenses. Other advantages include:

- They encourage entities or companies to embark on activities that they previously did not have the funds for, allowing them to cover the costs for their innovation, research and development.
- They allow additional employees to enter the workplace and lower unemployment
- Conditional grants can raise the local economy and improve an industrial area that was previously not as profitable as other areas.

Disadvantages of Grants:
Grants can be difficult to get as competition to receive one is fierce, many businesses compete for a small number of available grants. In order to be considered for a grant, make sure your application stands out from all the others. A disadvantage of using a grant as a funding source is that grants require a business to spend money and resources in the application process, when receiving one is not guaranteed.

As discussed previously, the grant recipient has an obligation to fulfil every requirement (strict spending and accounting rules and regulations). For example, a grant from a local government may have only been given to you with the intention of boosting the economic activity in that area. Therefore, you may be required to set up an office and hire local staff at that location, even if that is not that best option for the business.

Preparing a grant application is an art, and the individual must make sure their application meets the selection criteria. Successful proposals require proper planning and research to ensure they meet the detailed requirements and specifications of the grant. The economic conditions will determine the amount of funding available, hence in periods of recession—the process becomes more competitive.

Grants may become repayable due to nonfulfillment of the conditions attached to the grants. In such a case it may also mean any assets or services that used the grant may not be completed if it becomes repayable (such as a bridge) (Mackenzie et al. 2014). All grants require a business plan to be presented which consists of a budget, scheduled milestones and project goals that are required to be completed within a set of established parameters. Grants are funded by the government and therefore are subject to comprehensive government oversight and audits, it is recommended that a successful grant recipient hires an accountant to assist with compliance of all reporting requirements.

Additional Information:

It is very important to remember that no one can guarantee that a grant application will be approved. conduct your own research and seek the advice of an expert about securing a grant award.

Conclusion

As discussed previously, there are many types of financing options and routes available for entrepreneurs to start or grow their business. Putting all your eggs in one basket is never a good business strategy—always diversify, especially when it comes to financing your business. Entrepreneurs need to have a good understanding of the pros and cons of each type of financing option and know how to diversify their financing sources to better manage growth projects and mange any business stress scenarios.

Reflection Questions

Q1) What government policies and programs are available for entrepreneurs?
Q2) What are Angel investors and what is their role?
Q3) What are the advantages of a Venture Capital?

Compulsory Reading

- *Neck, H. M., Neck, C. P., & Murray, E. L., (2017). Entrepreneurship: The Practice and Mindset. Sage Publications. (Chapter 13, pp.336-349).*
- *Key Terms Table (Appendix 1)*

Additional Readings

- *Grants in Australia (2018). The secrets of success: An analysis of a national survey of Australian grant seekers, August 2018.*

S9.8 Funding Instruments for Entrepreneurs

Introduction

A debt contract is an agreement in which the borrower agrees to repay funds to a lender. For example, in a mortgage, the borrower agrees to make monthly payments to the bank. Debt can be used to finance short-term purchases or long-term assets. For example, borrowing to fund operating activities to start-up a business. The debt must be recorded as debit in the cash account and credit the debt payable account, likewise report the debt contract in a balance sheet.

S9.8.1 Debt Instrument

A debt instrument is a contract between a lender, a party loaning money, and a borrower, a party borrowing money. The debt instrument enables the lender to loan funds to the borrower, who promises to repay the loan. Figure 8.1 outlines the common types of debt instruments.

Compulsory Reading

Loans	- Loans are possibly the most easily understood debt instrument. A loan is a debt instrument where one party, the lender, gives another party, the borrower, money, property, assets or material goods based on a promise by the borrower that the loan will be repaid with a time, including interest and finance charges. - For large loans, the borrower will be required to provide collateral property. Loans can be acquired from financial institutions or individuals and can be used for a variety of purposes. Loans can be for a fixed period or open-ended credit line with a limit.
Mortgages	- A mortgage is a loan of money which you get from a bank or other financial institution to buy property. The loan is secured by the associated property. - More specifically, if the borrower fails to pay, the lender can take the property to fulfil the outstanding debt.
Bonds	- There are many types of bonds. They vary according to who issues them (government or business), the length until maturity, interest rate and risk. A bond, also sometimes called a fixed-income security, and if issued by a business is called a corporate bond. - The loan is to be paid back over a period with a fixed interest rate and is often secured to fund projects. A corporate bond is not the same as a government bond, which is low risk investment.
Leases and Notes	A finance lease also know as a capital lease is a type of lease in which a finance institution is typically the legal owner of the asset for the duration of the lease, which the lender not only has operating control over the asset, but also substantial share of the economic risks and returns from the change of the valuation of the underlying asset.

Figure 8.1 Types of Debt Instruments for Entrepreneurs

S9.8.2 Mezzanine – Preferred Shares

One of the most common methods of funding a mezzanine loan is through the issuance of Preferred Stock. There is a preferred status attached to preferred stock, which means they get paid off prior to the common stockholders, who get paid off last. This allows it to qualify for our middle seating of being in the mezzanine. There are two main differences:

1. **Dividends**
   Preferred stock often has a regular and reliable dividend where common stock may or may not have a dividend. Dividends are typically guaranteed to preferred stockholders, where there is no assurance a dividend will ever be paid to a common stockholder. This aspect and the higher priority of payoff from the company make Preferred stock closer to a hybrid security of part stock and part bond. Thanks to the regularity of payments, it's also called a Fixed Income Security.

2. **Voting Rights**
   Preferred shares often have no voting rights as their claim on the company is more senior to the common stockholders and payment to them is expected, like a bondholder, but in the form of a dividend. Common stockholders do have voting rights and can elect the Board of Directors to implement their plans for the company.

Preferred Stocks Use in Mezzanine Financing:

There are 3 common methods of using preferred stock in funding mezzanine transactions and they are;
1. All preferred stock
2. Some debt and some preferred stock
3. Use of convertible preferred stock

Since preferred stock falls in line with our 'middle' definition of mezzanine, then this means that a mezzanine lender can choose to fund a deal entirely with preferred stock. This can and does happen. What is more common is to have a debt component where there is some borrowing.

ASIC's Investment warnings — Safety first

Help yourself avoid bad investments by doing some basic safety checks recommended by ASIC before you hand over your money.

Company director fraud	How to tell if a company director is illegally using your investment for personal gain.
Illegal managed investment schemes	Unless the managed investment is registered with ASIC, it is illegal to offer units.
Initial Coin Offerings (ICOs)	Find out the risks of investing in blockchain technology projects.
Investment seminars	Be cautious, don't believe claims from any one—even experts promising that by investing with them they can guarantee you accessible returns and turn you into a millionaire.
Investment trading software	Be wary of claims you can make lots of money using investment trading software programs.
Land banking	This type of property investment has several risks. Find out what to check before investing.
Sports betting systems	At best, sports betting software schemes are gambling. At worst, they are scams.
Unexpected offers to buy your shares	These offers often try to buy your shares for much less than the current market price. You should be aware of some pitfalls if you get such an offer.
Cryptocurrencies	We explain how digital currencies work and the risks you take buying, trading or investing in them.

Table 8.1: ASIC's Investment warnings
Source: Australian Securities and Investments Commission. (2017).

Warrants (types/seniority)

A warrant is a security that entitles the holder to buy the underlying stock at a fixed exercise price until the expiry date, hence it gives the holder the right, but not the obligation to buy. Warrants have many benefits, including allowing the issuer to pay lower interest rates or dividends; cost-effectively diversify your portfolio; enhancing the yield of the bond; can also be used in private equity deals; provide leverage; can be sold independently of the bond or stock. However, some warrants also have risks, including: no guarantee fund protection if you buy warrants; liquidity risk and risk that the issuer will not honor its obligations. Table 8.2 summarizes the different types of warrants available.

Type of Warrants	Definition
Basket warrants:	As with a regular equity index, warrants can be classified at, for example, an industry level.
Covered warrants:	A covered warrant is a warrant that has some underlying backing instrument.
Detachable warrants:	A detachable warrant is a warrant that can be sold separately from the security it was initially attached to at a specific price within a certain time.
Equity warrants:	An equity warrant gives the holder the right to purchase shares at a fixed price (callable warrant) or the right to sell the shares at a specific price (puttable warrant).
Index warrants:	A stock index option issued by a corporate or entity as a tool to secure offering and guarantee by an option clearing corporation. The advantage is that risk is dispersed like a regular equity index.
Naked warrants:	A warrant is a security that is not attached to a bond or preferred stock but allows the holder to buy or sell.
Wedding warrants	A bond provision that requires the holder to return the bond to the issuer if the holder purchases another bond with similar features.

Table 8.2 Summary of Warrants Types

S9.8.3 Capital Market Structure

Capital markets is one of the means of transferring funds in the financial system, it plays a vital role as intermediaries in bringing together borrowers and lenders of funds. Capital market can be defined as a market where individuals and institutions trade financial securities of greater than one year to maturity, for example stocks markets, commodities exchanges and the bond market. Capital markets are intermediaries where debt and equity securities can be bought or sold.

1. **Primary market**
   Refers to the market in which investors purchase new financial securities from the issuer or a panel representing the issuer. Governments, companies, or public-sector organizations can obtain funding (stocks and bonds) in the primary market. These are normally issued through securities dealers and banks, which underwrite the offered stocks or bonds. The issuers earn a commission, which is built into the price of the security offering.

2. **Secondary market**
   Refers to the market in which investors sell their financial securities to other investors. Stock exchange consists of exchanges and facilities the issue and redemption of securities, including trading in other financial instruments, and the payment of income and dividends. However, the ease in which the securities can be converted to cash depends on the liquidity of the secondary market.

Advantages

- Capital markets provide serve as intermediaries between borrowers and lenders. They provide a safe platform for a wide range of investors —including commercial and investment banks, insurance companies, pension funds, mutual funds, and retail investors—to hedge and speculate.
- Capital markets create price transparency— gives important pricing information that permits efficient use of limited capital.
- Allow investors to diversify
- Provide access to short term funding and liquidity

Disadvantages

- In capital markets, bond prices are influenced by economic data such as employment, income growth/decline, consumer prices, and industrial prices. Any information that implies rising inflation will weaken bond prices, as inflation reduces the income from a bond.
- Prices for shares in capital markets can be very volatile. Their value depends on several external factors over which the investor has no control.
- Different shares can have different levels of liquidity (i.e., demand from buyers and sellers).
- Foreign firms are disadvantaged in the capital market because they incur additional costs (information costs, unfamiliarity costs - culture difference) when raising funds outside their domestic capital markets.

Conclusion

Entrepreneurial ventures need capital to start and survive. Debt instruments, including Mortgages, Loans, Bonds, and leases can prove to be an attractive way of rising finance for the short term, medium-term or long term. Mezzanines debt can also often fill a critical shortfall between senior debt capacity and the availability and equity funding. Equity holders might also prefer mezzanine debt to equity contribution because it reduces the risk of dilution (see Section 9.3). Finally, entrepreneurs can obtain funds from capital markets.

Reflection Questions

Q1) List and explain the different types of debts.
Q2) What are some of ASIC's Investment warnings?
Q3) explain the differences between primary and secondary markets?

Compulsory Reading

- *Neck, H. M., Neck, C. P., & Murray, E. L., 2017. Entrepreneurship: The Practice and Mindset. SAGE Publications. Chapter 1 (Page, pp.100-104)*
- *Silbernagel and Vaitkusna (2012). Bond Capital: Mezzanine Finance. Stern School of Business.*
- *Key Terms Table (Appendix 1)*

Additional Readings

- *Australian Securities and Investments Commission. (2017). Mezzanine investment. Retrieved from https://www.moneysmart.gov.au/investing/investments-paying-interest/mezzanine-investments*

- *Bell, R., Filatotchev, I. & Rasheed, A. J Int Bus Stud. (2012). The liability of foreignness in capital markets: Sources and remedies. Journal of International Business Studies. 43(2), 107-122.*

S9.9 Capital Structure and Implications

Introduction

There are no hard and fast rules for optimizing a company's capital structure, companies that are strategic use an efficient combination of senior debt, mezzanine debt, and equity capital to minimize their true cost of capital. Business owners need to analyze the difference between an ownership interest in a stagnant or underperforming business and an ownership in a growing company. Listed below are some of the equity and debt available to raise funds:

- Senior Bank Debt
- Subordinated Debt
- Shareholder Equity
- Quasi Equity
- Mezzanine Debt

S9.9.1 Senior Bank Debt

Senior bank debt is the borrowed money that a company must repay first if it goes out of business. The loan is considered senior to all other claims against the borrower, meaning the collateral can be sold to repay the senior debt holders first, followed by junior debt holders, preferred stock holders and common stock holders. This makes the senior bank debt a lower risk to the borrower and therefore a lower interest rate.

S9.9.2 Subordinated Debt

Subordinated debt is a debt that can only be claimed by an unsecure creditor, in the event of a liquidation, after claims of secured creditors have been met. Subordinated debt has many benefits, including capital growth and recapitalizations. Taking into consideration high interest rates on subordinated debt, if the business is profitable, subordinated debt is a better option than a pure equity injection.

S9.9.3 Quasi Equity

Quasi-equity debt security (revenue participation investment) is useful for organizations that are legally structured non-profits and therefore cannot obtain equity capital. This type of security is a form of debt, but its returns are indexed to the organization's financial performance (Bugg-Levine et al., 2012). In scenarios where the expected financial return is not achieved, the investor may receive a lower or zero return. Conversely, if performance is better than expected, then a higher financial return may be payable. One of the advantages of Quasi-equity is that it provides a reward between investor and investee with equal sharing of risk.

S9.9.4 Shareholder Equity

Shareholder equity is defined as total assets minus total liabilities of a corporation. Shareholder equity (see figure 9.1) represents the money that has been invested in the business plus the cumulative net profits and losses the company had generated. There are two main components of shareholders' equity:

1. **Retained earnings**
   Retained earnings are the accumulated profits a business has held on to and not paid out to its shareholders as dividends.

2. **Capital stock**
   Capital stock is the original amount the owners paid into the company plus any additional paid-in capital to purchase stock in the economy.

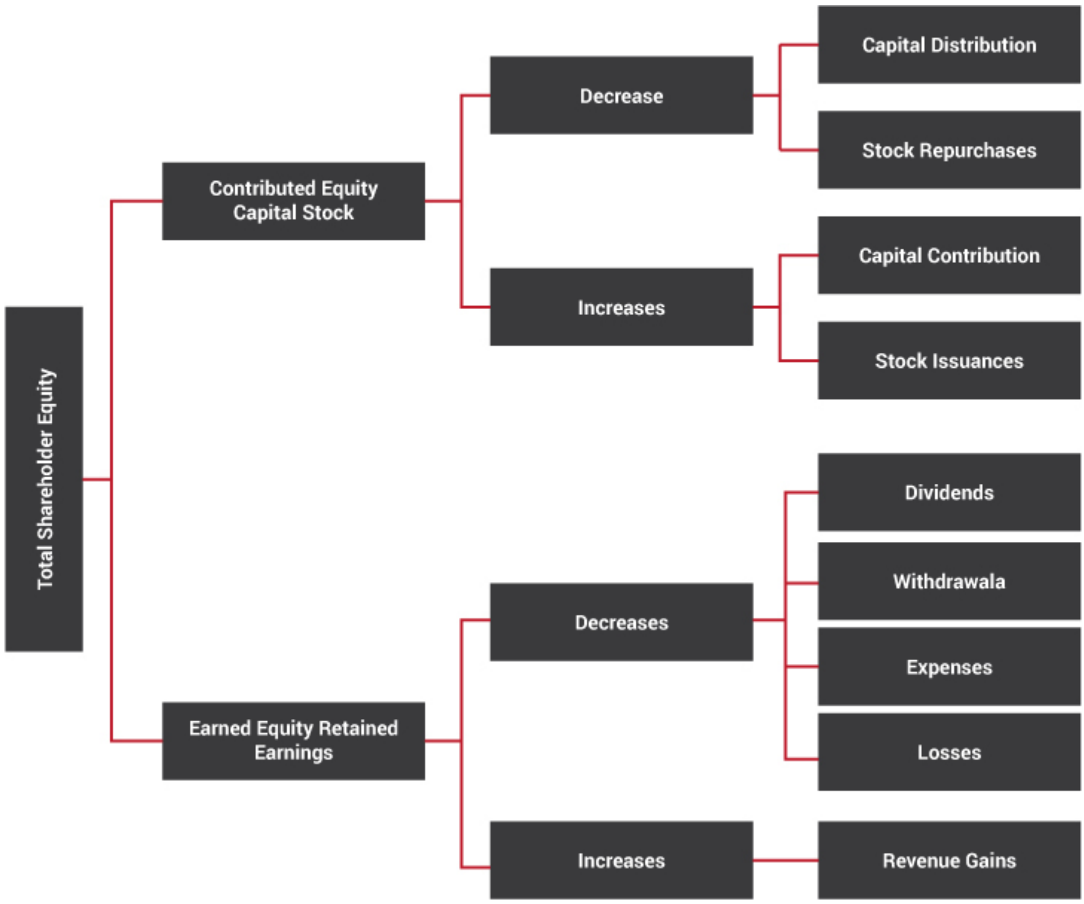


Figure 9.1 Total Shareholder Equity
Extracted from: Neck et al. (2017, p365)

S9.9.5 Mezzanine Debt

Mezzanine debt is used by companies that are cash flow positive to fund and that want to grow through expansion projects; acquisitions; recapitalizations; and, management and leveraged buyouts the typical mezzanine transaction is for 5 to 8 years, with the possibility of early exit and most Mezzanine investments are taken out either through a change-of-control sale or recapitalization of the company.

As an equity, Mezzanine is the most cost-effective capital structure that secures the most funding, maximizes return on equity and offers the lowest cost of capital. Listed below are some of the advantages:

- Mezzanine debt reduces transaction costs.
- Mezzanine is cost effective—investors are looking for between 15 and 25 percent IRR (internal rate of return) compared to 25 to 50 percent for equity investors.
- Mezzanine debt can be an attractive alternative way to obtain much needed capital and shareholders face lower dilution and maintain their control of the business;
- While mezzanine debt is more expensive than bank debt, it is not as rigid.
- Mezzanine debt used in combination with senior debt can reduce the amount of equity required in the business.
- Companies with Mezzanine debt are considered a safer investment for banks.
- Mezzanine investors are not long-term shareholders, but rather short-term investors looking to achieve a target return rate by some specified time.

Heller (2012) highlighted that Mezzanine loan is indirectly secured by the investment property, by a security of the equity in the entity that owns the property. Mezzanine debt capital generally refers to that level of financing between a company's equity and other forms of debt. Table 9.1 below summarizes what the literature suggests about are the differences between Mezzanine Loans and Preferred Equity.

Compulsory Reading

Right or Remedy	Mezzanine Loan	Preferred Equity
Repayment	Mandatory repayment at specified maturity date.	Mandatory redemption right at specified date
Return	Fixed or floating interest rate (may also have an "equity kicker," but usually does not)	Fixed or floating preferred return rate (often with additional "equity kicker")
Priority	Structurally subordinate to mortgage debt, but prior to common equity	Subordinate to other debt, prior to "common" equity as to return on (and often return of) capital
Control of "major Actions"	Covenants in loan documents; action without mezzanine lender constant is an event of default (and for some actions, a guarantor recourse trigger)	Approval rights embedded in entity governing documents, legally disabling entity from acting without preferred equity holder consent
Protection against bankruptcy	Requirement that "independent manager" approve any bankruptcy filing; voluntary bankruptcy also deterred by making it a full recourse trigger in affiliate guaranty.	Requirement for preferred equity holder approval of any bankruptcy filing embedded in entity governing document disabling entity's ability to file voluntarily.
Recourse	Borrower is SPE whose only asset is 100% of equity in property owning entity already pledged to lender, so personal recourse against borrower is meaningless. Recourse against affiliated, creditworthy guarantor for "bad acts"	Recourse against other members in borrower entity (also likely, though to be SPEs). Similar recourse against an affiliate can be provided by a "put and indemnity agreement" with put obligation triggered by the same kinds of "bad acts"
Security	Pledge of equity interest in property owning entity	Direct holding of equity interest in property owning entity
Remedy for Breach	Enforce pledge of equity in property owning entity through UCC sale or foreclosure ("public" sale required for lender to be able to bid)	Rights of preferred equity holder to take over management of property-owning entity (by appointing replacement manager or directors) and compel sale of property embedded in entity governing document

Table 9.1 Difference between Mezzanine loans and preferred equity.

Extracted from: Heller (2012, p.42-43)

Lowering the Cost of Capital and Improving Equity Returns
Mezzanine capital structure allows a business to reduce its cost of capital and increase both the return on equity and profits. Silbernagel and Vaitkusna (2012) illustrated three case scenarios with different equity structure:

- (Case 1: Traditional) the capital consists of all equity.
- (Case 2: Typical Debt) the capital structure consists of bank debt and equity.
- (Case 3: High Leverage) Bank debt, equity and Mezzanine (non-bank Debt)

Diagram 9.1 shows the transition from traditional company into a more efficient capital structure through a **small recapitalization lowers** the company's cost of capital, improves the return on equity, and releases significant capital to a company's existing owners (Silbernagel & Vaitkusna, 2012, p.5).

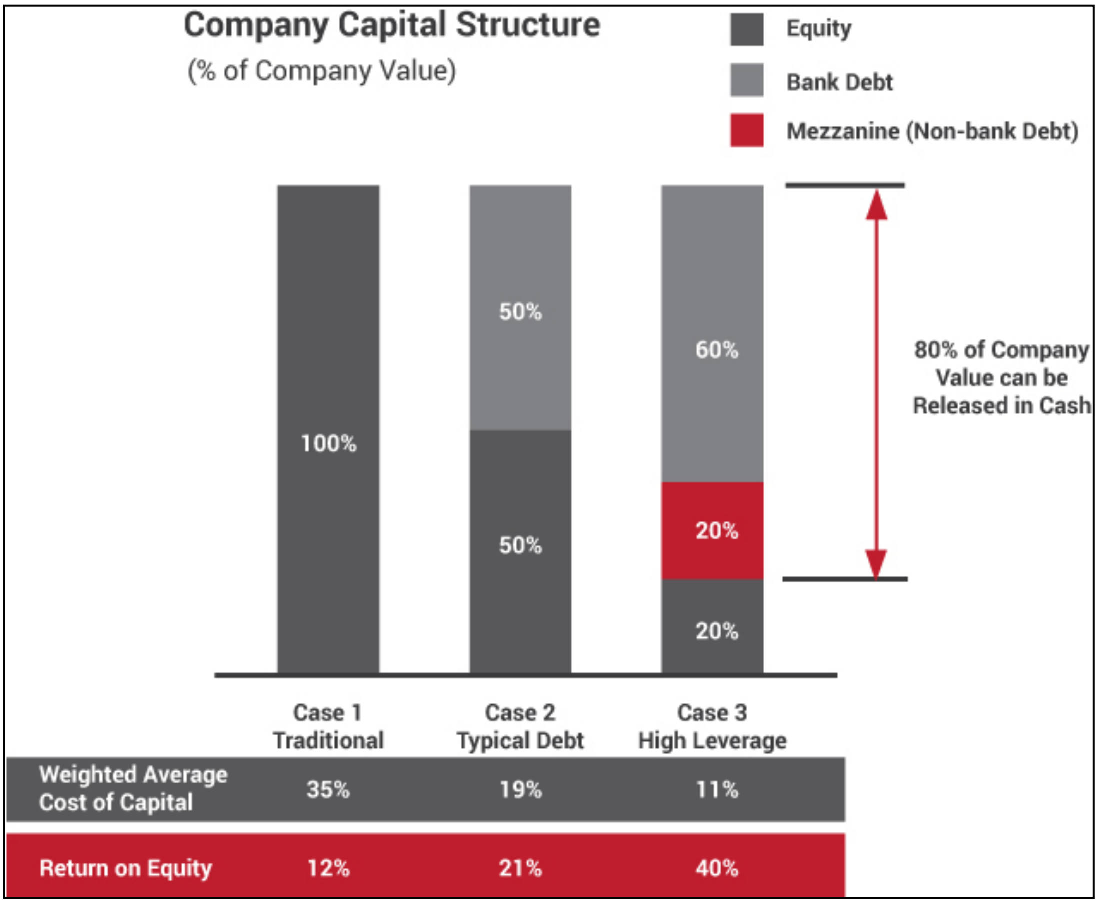


Diagram 9.1. Optimizing Capital Structure to Lower a Company's Cost of Capital Can Release Significant Value and Improve Return on Equity
Extracted from: Silbernagel and Vaitkunas (2012, p5)

S9.9.6 Dilution

Dilution is a result of a reduction in the ownership percentage of a company, or shares of stock, due to issuance of new equity shares by the company — I.e. When the number of shares available on the market for a company increases, each existing stock holder now owns a smaller or diluted percentage of the company. Dilution can cause changes in the value and ownership percentage, including financial returns— earning per share. This is a risk of investing in stocks that investors must be aware of. Listed below is an example:

Company XYZ has 10 shareholders, and each shareholder owns one share, or 10% of the company. If each investor has equal voting rights for company decisions based on share ownership, every shareholder has 10% control. If company XYZ wants to raise capital and issues 10 new shares and a single investor buys them all up, this would result in 20 total shares outstanding, and the new investor owns 50% of the company. In this scenario dilution would occur because now, each original investor only owns 5% of the company (1 share out of 20 outstanding).

As demonstrated by the example above, the decrease in the value of the investors' holding would not be pleasing to company's shareholders.
Ownership can be diluted in the following ways:

1. **Secondary Offerings:**
   Secondary offerings can be defined as the sale of new or closely held shares by a company after an initial public offering (IPO). A dilutive secondary offering involves the creation of new shares for an additional offering, while a non-dilutive secondary offering is a sale of securities by a major stockholder.

2. **Convertible Debt/Convertible Equity:**
   Convertible debt refers to debt holders who choose to convert their securities into shares, however it will dilute current shareholders' ownership when they convert. Convertible equity (convertible preferred stock) are shares that usually convert to common stock on preferential ratio.

3. **Warrants, Rights, Options and other claims on security:**
   The ASX defines warrants are a form of derivative, they derive their value from another underlying instrument, giving holders the right to buy, or to sell the underlying instrument to the warrant issuer for a price according to the terms of issue.

Compulsory Reading

Warning Signs of Dilution

Dilution causing a decrease in the value of the investor's holding would not be pleasing to company's shareholders and stakeholders. Share dilution is a major concern and investors need to be aware of the warning signs. Dilution can occur if the firm wants to grow and it does not have the capital finance current liabilities and the firm is restricted from issuing new debt due to covenants of existing debt; in this case an equity offering of new shares may be necessary. There are many ways investors can be diluted: if employees have been granted options or if individuals choose to exercise the option. Executives and Board members can also influence the price of a stock dramatically. For example, if the number of shares upon conversion is significant compared with the total shares outstanding.

S9.9.7 Price Earnings Ratio

The price/earnings ratio (P/E) is a measuring parameter or benchmark tool used to decide whether any stock is investment worthy, it looks at the relationship between stock price and the company's earnings. The P/E ratio is the most widely reported and used valuation method by investment professionals. Earnings per Share ratio measure a company's ability to produce net profit for common shareholders.

The formula 1:

$$\boldsymbol{EPS} = \frac{Net\ Income}{Shares\ Outstanding}$$

The formula 2:

$$\boldsymbol{Price/Earnings\ Ratio} = \frac{Price\ per\ Share}{Earnings\ per\ Share}$$

Example:

Company XYZ share price is $40 and Earnings per Share is 8, calculated by the EPS formula.

P/E Ratio = $\frac{\mathbf{40}}{\mathbf{8}} = \mathbf{5}$

The P/E Ratio value of 5, means that the market is prepared to pay $5 now for every dollar of earning from Company XYZ stock.

Some thumb rules:

- The P/E Ratio gives investors an idea of what the market is willing to pay for the company's earning—the perceived value of a particular stock.

- A higher P/E Ratio shows willingness of market to pay more for the company's earnings.
- A low P/E Ratio may indicate a vote of no confidence by the market which means the investors have undervalued the stock due to lack of confidence in its future growth.
- The P/E ratio is influenced by economic and market conditions, but the value of the ratio varies widely among firms and industries, but it should not be used in isolation but compared to other firms within the industry.
- Disadvantage: is affected by a range of factors and past values not be a reliable guide to future PES values.

Factors affecting P/E Ratio

- Growth
- Risk
- Past Track record
- Government Vision
- Performance of the Economic

Variations:

There standard method to calculate the P/E Ratio uses earnings per share, however, there are several variations in the numbers used for the EPS figure in the denominator, including:

- Basic earnings per share
- Estimated basic earnings per share
- The Value Line Investment Survey's combination approach
- Cash Earnings Per Share
- Other Earnings Per Share

Conclusion

Entrepreneurs can use debt to finance short-term purchases or long-term assets, including: Shareholder Equity; Senior Bank Debt; Subordinated Debt; Quasi Equity; and Mezzanine Debt. Each of these have advantages and disadvantages and will determine the company's capital structure, which will ultimately determine the of financing and impact return on equity. It is up to the entrepreneur to determine the optimal capita structure.

Reflections Questions

Q1) Define the following terms:

1. *Senior bank debt*
2. *Quasi Equity*
3. *Shareholder Equity*

Q2) What are the benefits of Mezzanine Debt?

Q3) List five differences between Mezzanine loans and preferred equity.

Q4) How can an entrepreneur lower the cost of capital?

Compulsory Reading

- *Neck, H. M., Neck, C. P., & Murray, E. L., (2017). Entrepreneurship: The Practice and Mindset. Sage Publications. Chapter 13 (page 329 – 336)*
- *Key Terms Table (Appendix 1)*

Additional Readings

- *Heller, J. D., (2012). What's in a Name: Mezzanine Debt Versus Preferred Equity. Stanford journal of Law, Business & Finance. 18(1), 40-71.*

S9.10 Succession Planning & Exit Strategy

Introduction

Succession planning can be defined as a process for identifying and developing key leaders within your company (Gray, 2014). The key to succession planning is making sure the business continues by transferring leadership and/or management to the next generation or among some collection of existing related shareholders.

Compulsory Reading

S9.10.1 Succession Planning

As you begin to develop a succession planning process, they should consider these fundamental issues:

- **High potential vs. everyone**
  Some companies focus all of their succession planning efforts on everyone from the moment they join the company whereas others focus their succession plan on 'high potential individuals'. While resources are limited, by focusing on high-potential workers to channel resources and coaching them, there is a risk of overlooking great people and alienate and frustrate the rest of the employees, which can have a negative impact and increase turnover.

- **Hiring from within vs. bringing in someone new**
  There are pros and cons of promoting from within or bringing on someone new, while developing leaders internally requires time and effort, internal candidates are more likely to be successful than external candidates, as they know the organization's culture and are likely to be more engaged and loyal. However, internal hires aren't always an option and may not always be the best choice. In cases where current management leave, or the company wants to make dramatic changes, the best alternative may be to hire someone from the outside.

- **Factoring diversity into decision-making**
  Diversity in leadership is important to any organization. The succession planning needs to include actions to promote women and minorities for leadership opportunities, including training for future managers.

- **Making sure you have support from the top**
  The organization can have a great talent development strategy, but for it to be successful it needs the support from its leaders and executives. Therefore, a succession planning strategy needs to involve and educate both managers and executives about the benefits to the organization.

S9.10.2 Common Mistakes to Avoid in Succession Planning

Companies make many mistakes when it comes to succession planning. Listed below are some common mistakes—and how to avoid them.

Compulsory Reading

1. **Use past experiences to plan for the future:** Choose leaders whose skills align with the long-term strategic goals and vision of the organization.

2. **CEO and senior management:** For a succession planning program to be successful the entire leadership and management team need to be involved in the process.

3. **Involve Board:** Many organizations only include the CEOs and HR in their succession plan, only to discover the board disagrees. For a succession planning program to be successful the board of directors also need to be involved in the process.

4. **Human capital roadblocks:** For a succession planning program to be successful the organization needs to create opportunities for new positions so future leaders have room to grow.

5. **Succession should be part of the organizational culture.** Succession planning needs to encourage and support executives to mentor talented young leaders.

6. **The Board and HR should be making decisions**. It is recommended HR and the Board make succession planning decisions, as the CEO may not be in the best position to choose their successor.

Table 10.1 outlines the three phases: 1) Plan; 2) Do; and 3) Review to help entrepreneurs implement the planning and execution of your succession planning program.

Succession	
Plan	• Identify whether the organization has employees with the right skills and attributes or whether the organization needs to outsource. • Design the long-term strategy and identify the skills and experience needed for key roles. • Evaluate whether HR has the software succession planning tools or whether the organization needs to outsource it.
Do	• Evaluate employees' skills and knowledge and whether they are suitable to the future roles and if they are interested in the position. • Each future role should have at least two candidates. • Once the organization has identified the individuals for future roles, provide education and training, including mentoring to close any skill gaps.
Review	• Review succession planning every 9 to 12 months to ensure it aligns with strategic goals. • Identify any gaps or shortages in employee's knowledge and skills and design strategic solutions.

Table 10.1 Succession Phases

Source: Gale, S. F., (2013) Succession Planning Roadmap. Retrieved from https://www.workforce.com/2013/03/11/succession-planning-roadmap/

S9.10.3 Exit Strategies

Entrepreneurs build businesses, and if successful, a business is worth a fortune; but entrepreneurs also need to make sure they have an exit strategy, a way to get the money back out. The exit strategy and planning is a way to transition one's ownership of a company or the operation of some part of the company to new owners or management. Entrepreneurs and investors will also plan to recover any capital they have invested in a company. The most common strategy is the sale of equity to someone else through a trade sale.

From time to time, management may decide it is necessary to downsize its operations. This typically involves discontinuing less profitable brands, products, product lines, or operating divisions. Other exit strategy includes management buyouts or employee buyouts.

Exit Strategies for Long-Term Involvement

- Let it run dry
- Sell your shares
- Liquidate

Exit Strategies for Short-Term Involvement

- Go public
- Merge
- Be acquired
- Sell

Types of exit barrier

- High investment in non-transferable fixed assets.
- High redundancy costs.
- Other closure costs.
- Potential growth

Compulsory Reading

Exit Strategies for Long-Term Involvement

- **Let it run dry:** one possible strategy prior to exit, especially for small businesses such as sole proprietorships is for the owner to increase their salary and bonuses, while making sure all debt is paid.
- **Sell your shares:** when the owner is ready to retire, they can sell their shares to any partners or in the market.
- **Liquidate:** when the owner sells all assets and inventory at market value to pay off any remaining debt.

Exit Strategies for Short-Term Involvement

- **Go public:** is one strategy to exit but the disadvantage is that costs are high depending on the exchange and size of the offering.
- **Merge:** mergers can lead to economies of scope and scale and can be an excellent exit strategy. Also, you might have the option (if you choose) to stay involved in the company under an advisory role.
- **Be acquired:** there might be a potential acquirer that can keep the value for themselves, make sure the offered sale price reasonably covers the value of the business.
- **Sell:** one of the easiest strategies, with no costs and the owner can be negotiated for equity in the buying company, allowing the owner to earn dividends after the sale.

Barriers to Exit

Barriers to exit are obstacles that prevent the owner from exiting, these may include: exit fees, closure costs, inter-related business and contract clauses. In some cases, the exit costs might be higher than staying in the market.

Types of Exit Barriers

- **High investment in non-transferable fixed assets**. For example, in manufacturing companies, investment is heavily in capital equipment which is specific to one task involved and may not be easily recovered.
- **High redundancy costs**. Large companies with many employees, employees with high salaries, which stipulate high redundancy payments or other contracts, then the firm may face higher costs if its choices to leave the market.
- **Other closure costs.** Contract termination clauses with key stakeholders.
- **Potential upturn.** Firms may be willing to wait for economic conditions to improve.

Conclusion

Succession and exit planning ensure that there is no leadership vacuum after the retirement or exit of a senior officer in the organization in order to ensure a firm's longevity. Entrepreneurs need to acquire impartial advice on many different options available, from how to identify a potential successor internally to designing an exit strategy.

Reflection Questions
Q1) Why is succession planning important, and what are the three phases?
Q2) What are the common mistakes entrepreneurs make when designing a succession plan?
Q3) List and explain the types of exit barriers.

Compulsory Reading

- *Gray, D. (2014). Succession Planning 101. Professional safety. 59(3), 35.*

Additional Readings

- *Dreux, D. R., Etkind, S. M., Godfrey, J. E., & Moshier, M. E., (1999). Succession planning and exit strategies. The CPA journal. 69(9),30-35.*

CASE STUDY

Case Study: Innovative Organizations —Amazon.com

Sources:

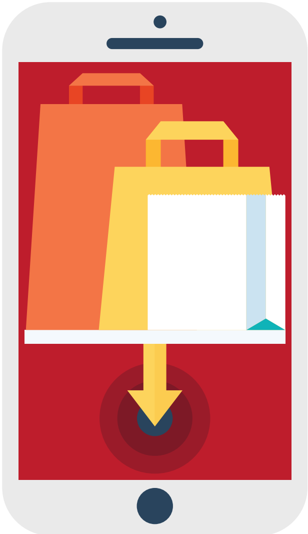
1. Neck, H. M., Neck, C. P., & Murrary, E. L., (2017). *Entrepreneurship: The Practice and Mindset.* Sage Publications. (Chapter 7, pp.181).
Robischon, N. (2017). Why Amazon is the World's most Innovative Company of 2017. Retrieved from https://www.fastcompany.com/3067455/why-amazon-is-the-worlds-most-innovative-company-of-2017

Amazon.com is an electronic commerce and cloud computing company founded by Jeff Bezos. It is known as the largest internet retailer in the world when measured by revenue and market capitalization. Jeff Bezos was quoted saying "Our customers are only loyal to us right up until the second somebody offers them a better service", this highlights the importance of innovation to Amazon as their main goal is to stay ahead of its competitors.

As Amazon explained in Securities Exchange Commission (2005) "Its current strategy is to focus its development efforts on continuous innovation by creating and enhancing the specialized, proprietary software that is unique to its business, and to license or acquire commercially-developed technology for other applications where available and appropriate. It continually invests in several areas of technology, including its seller platform, A9.com; our wholly-owned subsidiary focused on search technology on www.A9.com and other Amazon sites, web services and digital initiatives."

Amazon's latest example of innovation, is their launch of Amazon Go, which is a check out free store which offers a "Just Walk Out Shopping Experience". Using the Amazon Go App customers enter the store, grab the products they desire and simply exit the store without the hassle of waiting in line and going through a checkout.

- Watch this video: https://www.youtube.com/watch?v=NrmMk1Myrxc

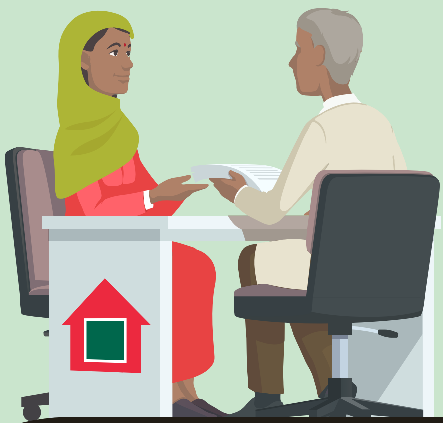


Social Entrepreneur

Muhammad Yunus

Nobel Peace Prize

Nobel peace Laureate, Muhammad Yunus is highly recognised in the world for his entrepreneurial innovation for helping disadvantaged communities through his pioneering bank, the Grameen bank.



Yunus is a social entrepreneur for founding the Grameen Bank and lending microcredit in the form of microloans to start-up entrepreneurs that require help when they are too poor to qualify for traditional bank loans.

His objective was to help poor people escape poverty, as he believed that credit is a fundamental human right, and by providing loans suitable to them and teaching them a few sound financial principles, they could begin to help themselves.

The Grameen Bank has advanced to the forefront of eradicating poverty and the bank has been replicated in more than 100 countries worldwide.

Sources:

Neck et al. (2017, Chapter 1, pp. 22. Chapter 4, 115-116).

Nobel Media AB. (2018). Muhammad Yunus Biographical. Retrieved from https://www.nobelprize.org/prizes/peace/2006/yunus/biographical/