CHAPTER 4 Entrepreneurial Strategies

***Profits** are not made by differential cleverness, but by differential stupidity.*
—Attributed to David Ricardo, Economist, *by Peter Drucker*

OUTLINE

LEARNING OBJECTIVES

After reading this chapter, you will understand

- how entrepreneurship is related to *strategic management.*
- the value and purpose of a *business model.*
- five different *hierarchies of strategy* that an entrepreneur can employ.
- what an *entry wedge* is, and the different major and minor entry wedges.
- three *resource-based strategies* an entrepreneur can use to achieve sustainable competitive advantage.
- *first-mover advantage and isolating mechanisms.*
- strategies for *information-based* ventures.
- five different *industry environments,* each with its own unique *life cycle.*
- how to craft and evaluate *entrepreneurial strategies.*

PERSONAL PROFILE 4

Tony Hsieh: Strategy That's A Step Above

His first entrepreneurial success came at the age of 12; Tony Hsieh made pin-on buttons with photos, and then sold a couple of hundred dollars worth to his classmates every month.

At Harvard he sold pizzas in the dorms; his friend Alfred Lin bought some of those pizzas, and resold them by the slice.

Armed with a B.A. in computer science from Harvard, Hsieh went to work for Oracle, but in 1996 he started a banner ad swap program for small Web sites called *Link Exchange*. Hsieh and his former fellow student, Lin, sold that business to Microsoft in 1998 for $265 million. They then used some of the money they received to found Venture Frogs, an Internet start-up incubator and investment company that invested in start-ups including Ask Jeeves, MongoMusic, and Zappos.com.

In the words of one of their customers, Zappos is a "shoe store that comes to you." Its Web site offers more than 500 brands and 90,000 styles for both women and men, and there are almost two million items in stock. Hsieh became interested in Zappos when he learned that only $2 million of the $40 billion in annual shoe sales was attributable to mail order. A 1999 survey reported that only a third of Zappos' customers had purchased shoes by mail order before, but Hsieh believes that in the future 30 percent of all retail purchases will be online. "Over time I saw there was a lot of potential for the company," he says.

Zappos had already hired an experienced shoe buyer from Nordstrom, a department store famous for its selection of shoes, when Hsieh became the company's CEO in 2000. Under Hsieh's leadership, gross merchandise sales grew from $1.6 million in 2000 to $370 million in 2005. After his old friend, Alfred Lin, joined the company as CFO in 2005, Hsieh predicted that Zappos would reach $600 million in sales and become profitable by the end of 2006.

An almost fanatical devotion to customer service distinguishes Zappos from its competitors. In addition to offering a wide selection of shoe styles and sizes, the company provides both free delivery and free return shipping. It warehouses every item it sells under one roof in Kentucky. Because the warehouse is staffed around the clock, seven days a week, customers can often order shoes as late as 11 p.m. and still get next-day delivery. To emphasize its commitment to customers, Zappos locates its customer call center in the same building as the company's corporate headquarters in Las Vegas. These strategies must work; Zappos does very little advertising, and credits repeat business and word-of-mouth recommendations for its phenomenal growth.

Zappos isn't just good to its customers. All employees get a free lunch every day, and the company pays 100 percent of employee health insurance premiums. Suppliers like Zappos, too. "You can't believe how pleasant they are to work with," says a regional manager for Clarks Companies North America.

SOURCE: Adapted from Kimberly Weisul, "A Shine on Their Shoes," *Business Week*, December 5, 2005: 84 http:// www.zappos.com.

WHAT is the most common criticism that entrepreneurs hear about their business ideas and new venture strategies? It is, If that's such a good idea, why hasn't someone else already done it? The answer, implied by David Ricardo in the introductory quote, is that most people never have a good idea, and many who do lack the faintest clue about what to do next. Human intelligence and energy are the scarce resources. There are countless business ideas for creating and operating profitable enterprises, but most of them have not yet been conceived or implemented. The resource-based view of the firm values creativity and intelligence. The strategy and resource configurations can be sources of SCA.

A business idea is not a business. The design, development, and implementation of a business require that the entrepreneur make certain strategic decisions about the venture's configuration. These decisions form the initial vision and objectives for the business. Although it is possible to alter the decisions in the future, it is very difficult to change the fundamental economics and structure of the firm. In this chapter, we will develop the embryonic venture idea into a fully workable business model with a sustainable strategy.

Our view is that there is an interaction between the resources, capabilities, experience, and vision of the entrepreneurs (internal factors) and the remote and operating environment of the industry (external factors) in the formation of new venture strategy. The entrepreneur must know how to integrate these elements into a cohesive and coherent business plan.

We will also examine some of the strategic choices available to new ventures. We will begin by looking at how strategy, resources, and entrepreneurship intersect. We will then present the concept of the business model followed by a discussion of the strategy choices available to entrepreneurs. Next, we will introduce the industry life cycle and see how the different stages influence new venture strategy. We will also look at the effects of fragmented environments. Then we will introduce two approaches that help entrepreneurs to craft their strategy. At the end of the chapter, we will present a model for assessing entrepreneurial opportunities and evaluating the strategies chosen.

ENTREPRENEURSHIP AND STRATEGY

How are entrepreneurship and business strategy related? Some of the concepts presented in this chapter are borrowed and adapted from the strategic management literature.[1] In this literature, **strategy** is defined as "the patterns of decisions that shape the venture's internal resource configuration and deployment and guide alignment with the environment."[2] This definition has two major implications. The first is that "patterns of decisions" means both **strategy formulation** and **strategy implementation**. Formulation includes planning and analysis. Implementation is the execution and evaluation of the activities that make up the strategy. The second implication is that the entrepreneur has to consider both internal factors such as the firm's resources and capabilities, and external factors such as the market environment. That is what we did in Chapters 2 and 3.

One of the core assumptions of strategic management is that strategy exists on different levels within the firm. In descending order, these are the enterprise, corporate, business, functional, and subfunctional levels. Part of the environment for each level is the level above it; lower and higher levels must be aligned, with the higher levels leading the way. One result of this hierarchy is a cascading effect. Strategy formulation starts at the top of the hierarchy and flows down to each level. As it does, strategy formulation is increasingly replaced by implementation. The cascade effect contributes to consistency and helps hold together organizations that are sometimes large and far-flung.

Enterprise-level strategy is at the top of the hierarchy. It is concerned with the relationships between the firm and society at large. The context for analyzing this strategy was presented in Chapter 3. **Corporate strategy** focuses on the problems of diversification and the management of a portfolio of business. Because the new venture is most often a single business, corporate strategy is not discussed in this book. **Business-level strategy** is oriented toward competing within a single industry. It deals with the acquisition, organization, and employment of resources. Industry analysis was examined in Chapter 3. The strategies that correspond to industry conditions are the subject of this chapter. In other words, this chapter is about business-level strategy. **Functional** and **subfunctional strategies** involve marketing, finance and accounting, and human resource policies, which will be examined in Chapters 6 through 9.

BUSINESS MODELS AND STRATEGY

A **business model** goes beyond the business idea and adds significant detail. A business model is not a strategy, but it is the basis of strategy. It is the story of the business.[3] This model tells the story by answering the following questions.

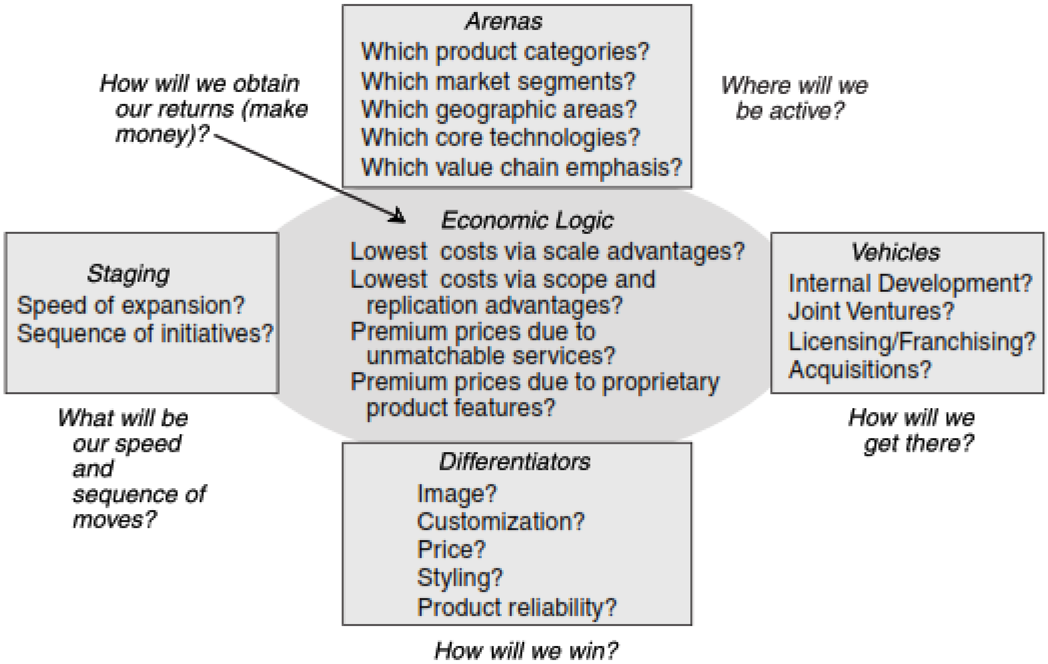
- Who are the customers?
- What do the customers value?
- How does our business make money?
- What is the underlying economic logic of the venture?

There are two parts to the story. The first part describes how we obtain the resources, people, money, materials, and inputs that we use to produce our product and services. The second part of the story tells who we produce the product for, the conditions of sale and delivery, the marketing process, and the flow of cash back to the business.

We must also include the notion of the **revenue model**. The revenue model tells the story of how the flows of sales and cash revenue will be accumulated. The spreadsheet details the financial narrative of the story. Through the spreadsheet, we are able to do sensitivity analysis that tells us how the story might turn out, given different assumptions, endowments, and starting conditions. This is the financial picture of the story and we will return to it in Chapter 7.

Hambrick and Fredrickson put these pieces together into a framework they called the **strategy diamond**.[4] While their business-model framework has five dimensions, it is similar to the questions raised above. The key difference is that the strategy diamond asks us explicitly to lay out the staging and sequencing of our strategy. Figure 4.1 summarizes the strategy diamond model.[5]

FIGURE 4.1 The Strategy Diamond



SOURCE: Adapted from D. Hambrick and J. Fredrickson, "Are You Sure You Have a Strategy?" *Academy of Management Executive*, 2001.

The first question to answer is: In which arenas will the venture compete? This is the initial part of the story of the business model. The next question is: What vehicles will we employ? At this point in the text, we have primarily been focused on internal development as the prime vehicle. The other collaborative and cooperative formats will be covered in Chapter 9. Here we note that creating the organization involves a set of strategic decisions.

The third question is: How will we be different? This is where our RBV theory and strategy come into play. We will be looking for resources that have the VRIN characteristics. The fourth question requires the firm to specify the staging of the decisions. In what order will the venture do things and how fast? All of these decisions converge on the center square. This is the revenue model described above.

Another way of looking at a business model was offered by Amit and Zott.[6] They emphasize the transactions and exchange themes of the story. These authors define a business model as "the content, structure and governance of transactions designed so as to create value through the exploitation of business opportunities."

Transaction content refers to the actual goods, services, and information that are being exchanged by the parties, and the resources and capabilities employed to facilitate the exchange. It represents the "what" of the story.

Transaction structure refers to the people or organizations involved in the transactions and how they participate—what their roles are (customer, vendor, and consultant). This represents the "who" of the story.

G**overnance of transactions** refers to the rules, protocols, customs, and methods of exchange used. It is the way in which these transactions are controlled, and may include the legal forms of the businesses and the transactions. It describes the "how" of the story.

Table 4.1 below summarizes a number of e-commerce business models. Some of these were very popular during the boom of the late 1990s; others have been around for many years and can easily be applied to nontraditional businesses.

For example, the mash-up combines the content of other Web-based models and attempts to integrate and add value based on these other sites. One such mash-up, Platial (http://www.platial.com/splash), is a mapping service for people, videos, and stories. All of the content comes from other places, but Platial has the software to integrate the content into a story. The revenue model is aimed at online advertising. But many investors feel that a mash-up like Platial is not strategically defensible because it cannot protect the resources it doesn't own or control. Others are not so sure. Platial received financial commitments from both Kleiner Perkins and Omidyar Networks.[7]

Street Story 4.1 offers us the example of an affiliate business model called Brad's Deals.

TABLE 4.1 Internet Business Models and Stories

Business Model Name	*Business Model Story*
Business to Business (B2B)	Selling to commercial organizations directly
Business to Customer (B2C)	Selling to final users and consumers directly
Business to Business to Customer (B2B2C)	Selling to commercial organizations and then selling through directly to final users and consumers
Niches (vertical or horizontal)	Selling to a very specific customer segment (vertically through the supply chain) or selling a very specific set of products (horizontally to a variety of customers)
Clicks and Bricks	Selling through both the Internet and traditional business location with a physical presence
Roll-ups	Buying many smaller firms using the same business model (usually in fragmented industries) and then achieving economies of scale or scope
Advertising Models	Selling advertising in a media (cyberspace, newspapers, magazines, etc.) and giving away the content
Pay-for-content Models	Selling the content through information rules type strategies
Affiliate Models	Selling products on a second-party Web site for a fee. Enables the affiliate to piggyback on a more famous Website like Amazon or eBay
Mash-ups	Selling a Web-based application that mixes data from different online sources

STREET STORY 4.1

I Can Get It for You (Almost) Wholesale

He works out of a 400-square-foot office with just a couch, fax machine, phone, white board, and a couple of computers. He has two part-time employees. He doesn't manufacture any items or inventory any products, and he doesn't have any special training or unusual skills.

Still, Brad Wilson's company took in over $1 million in revenue in 2005, and Wilson expects to do even better now that his Web site has a new name and some new features.

Wilson's site is an online discount shopping portal for savvy bargain shoppers. He started it when he was a student at the University of North Carolina at Chapel Hill, after negotiating a super low price for a 27-inch flat-screen TV from Amazon.com by combining Amazon's sale price, an e-coupon, and a free shipping offer. Friends and family asked him to find similar online deals for them, so Wilson created dealsdujour.com, an "affiliate" site that referred consumers to vendor sites with sale specials and other good deals in exchange for a fee from the vendor.

The site is now known as BradsDeals (www.bradsdeals.com). Wilson works with more than 700 merchant partners, including clicks and bricks retailers like Gap, Office Depot, Target, and Internet stores like Amazon.com and Overstock.com. Under the trademarked slogan Handpicked Deals™, BradsDeals lists a handful of specials every day. Each item has a brief description explaining why it is such a good deal, and a link to click through so that the shopper can get that low price and Wilson can get his commission. Shoppers can also use the affiliate site to search for deals by vendor or by category (such as apparel, cars, or pets). They can also use the site to access coupons that are good at retailers like Dick's or Kohl's.

Wilson claims that approximately 1.5 million shoppers have spent more than $100 million at the sites of his merchant partners. "We have tried to create a user-friendly site and a complete shopping experience for our visitors," he explains. BradsDeals has been honored by the online marketing industry for helping Internet retailers acquire new customers and increase their revenues.

SOURCE: Adapted from Gwendolyn Bounds, "Finding Good Bargains Is Also a Good Business," *The Wall Street Journal*, January 4, 2005. Retrieved from the Web January 4, 2005. http://online.wsj.com/article_print/O,,SB110479919259915983,00.html, and www.BradsDeals.com.

ENTRY WEDGES

Entry wedges are momentum factors.[8] They are part of the business model story. A wedge is not really a full-blown strategy, but is rather the methods the founders use to get their initial foothold in a business. Because the entry wedge becomes an important part of the firm's unique history, it may, from an RBV perspective, influence later strategic decisions. Unique historical conditions are impossible to copy. Therefore, the entry wedge can be part of the firm's sustainable competitive advantage.

Major Wedges

All new ventures employ one or more of three major entry wedges: new product or service, parallel competition, and franchising.

New Product or Service. A new product or service is one of the most potent entry wedges. Truly new products and services are relatively rare. If they include a new technology as well, they may be hard to imitate. Typically, new products have a lower failure rate than new services, primarily because most service organizations face lower entry barriers. Firms that do use the new-service wedge are likely to offer or introduce a related product if they gain a foothold in the industry. Ventures that initially offer a new product sometimes follow up with a related service, but this is less common.[9]

The new product or new service wedge is what Drucker called the "being first with the most" strategy.[10] This strategy is used to achieve a permanent leadership position either within an existing industry or by creating a new industry. Success with this strategy requires a concentrated effort at being comprehensive and innovative. "Being first," like the first-mover advantage, gives the firm a head start and possibly an insurmountable lead in market share, in low-cost manufacture and supply, and in public awareness and recognition. "With the most" requires that the product or service be comprehensive. If it is missing something (for example, service, warranty, delivery, or functional components that customers require), the door is left open for competitors. This is the high-risk, high-reward entry wedge. Table 4.2 below illustrates some of the types of new products that have been introduced in recent times and are considered award winners. (Students might want to research these companies to see what particular uniqueness they have brought to market.)

Parallel Competition. Parallel competition is a "me too" strategy that introduces competitive duplications into the market. These duplications are parallel, not identical, to existing products or services. They represent an attempt to fill a niche, a small hole in the market. This can be done with a small innovation or a variation in an already well-accepted and well-understood product line or service system. An entrepreneur who notes that a firm's current customers are unhappy and who conceives of a strategy to make them happy would be entering with a parallel wedge strategy. Marginal firms always risk being replaced by others that do basically the same things but do them better.

Most retailing start-ups, for example, enter with the parallel competition wedge. The difference between one retail operation and another might only be location or minor variations in merchandising and marketing. The typical retail store carries the same or similar products from the same suppliers and charges approximately the same markups as its competitors. This type of entry is fairly easy, because entry barriers are low. Firms of this type can produce stable income and profits over a long time if they possess some distinctive competence. More likely, though, these firms are low-sales, low-profit operations. For the entrepreneur, they are alternatives to other jobs and replace income from other employment. Without a distinctive competence, these small retailers quickly become marginal and risk being replaced by another firm using the parallel wedge strategy.

However, if used with creativity and vision, the parallel wedge strategy can lead to superior payoffs. Drucker calls this form of the parallel strategy **creative imitation**.[11] Creative imitation combines the common business configuration of the competition (the imitation part) with a new twist or variation (the creative part). Two types of com-

TABLE 4.2 Innovative New Product Ideas
The Wall Street Journal's 2005 Technology Innovation Award Winners

Company Name	*Industry*	*Winning Product Description*
454 Life Sciences*	Biotech-Medical	Low-cost gene-splicing method
Optimyst Systems Inc.	Medical devices	New device for applying eye medicines
Solar Integrated Technologies, Inc.	Energy and Power	Solar roof system designed for large commercial and industrial buildings
MIT team (nonprofit)	Environment	Low-cost water filtration system for developing countries
Ecological Coatings	Materials	Non-toxic, easy-to-use finishes and coatings
Riverbed Technology Inc.	Network/Broadband Internet	Steelhead network appliances that reduce delay between remote offices and servers
ObjectVideo Inc.	Security facilities	Software that monitors multiple-security camera feeds
Fujitsu Laboratories Ltd.	Security network	Network that reads the veins in the palms of hands as alternative to fingerprints
Alien Technology	Semiconductors	Low-cost method for RFID production
Agitar Software Inc	Software	Software that automatically tests programs for bugs and flaws
QinetiQ (UK)	Transportation	Tarsier high-resolution radar system
Freescale Semiconductor Inc.	Wireless	Wireless technology for consumer products that use "ultra wide band"

*Grand Prize Winner

SOURCE: M. Totty, "A Better Idea," *The Wall Street Journal Report: Technology*, October 24, 2005. Retrieved from the Web February 21, 2006. Http://online.wsj.com/article/SB112975757605373586.html.

petitors are susceptible to a new venture's creative imitation: those with weak spots and those with blind spots. Firms with weak spots may have the same resources as others but not employ them well. The new venture, without different assets but knowing how to use the assets it does have, has an advantage. Some entrepreneurs also have blind spots—things they do not see about the market, the competition, or themselves—that make them vulnerable to creative imitation. Examples include:

- The *"not invented here" syndrome.* Firms are sometimes slow to adapt innovations or are reluctant to change because they did not initiate an idea themselves. This syndrome makes the firms easy to target for the new venture that is quick to adopt the new standard. For example, the Polaroid corporation and Kodak waited much too long to adopt digital photography as their core technology. Polaroid is gone and Kodak is much diminished as a result.
- The *"skim-the-market" blind spot.* Here, firms that charge high prices and attempt to capture only the most profitable business are vulnerable. Other firms can

operate under their price umbrella, gain market share, and become close to their customers. The creative imitators learn how to add value by serving the tougher customers. Hertz Corporation and its rental car business is the high-priced provider. There are literally dozens of car rental companies that operate under Hertz's price umbrella. These companies owe their very existence to Hertz's reluctance to discount.

- *Technologcial tunnel vision.* Firms that emphasize product- and manufacturing-based quality to the exclusion of user-based quality have technological tunnel vision. They are vulnerable because they fail to notice minor changes in customer needs and perceptions that are obvious to the imitator. The makers of cell phones have been guilty of this. For many segments of the market, they offer too many features and the phones become more complex with each generation. Apple Corporation is offering the iPhone as a simpler and more integrated product.
- *The maximizer complex.* Firms that try to do too much, that serve all types of customers with all types of products and services, are vulnerable because they may not serve any customers particularly well. A parallel competitor who carves a niche to serve a specialized customer base can succeed here.

Franchising. The third major wedge is franchising. It is a twist on both the new product and me-too wedges. Franchising takes a proven formula for success and expands it. The **franchisor** is the seller of franchises. The franchisor is attempting to create something new and offer it to the market. For the franchisor, franchising is a means of expanding by using other people's money, time, and energy to sell the product or service. These other people are the **franchisees**. In return for a franchise fee and royalties (usually based on sales), they gain the expertise, knowledge, support (training, marketing, operations), and experience of the franchisor, which reduces their risk of failure. The franchisee is pursuing a me-too strategy as one of a potentially large group of franchises. For example, Subway sandwich shops offer the same products through thousands of outlets. For franchising details, see http://www.subway.com.

The key to franchising power is for the franchise system to expand geographically under a license agreement. Geographic expansion enables the franchise system to saturate markets. Saturation gives the franchise the benefits of visibility and recognition, logistical cost savings, volume buying power, lower employment and training costs, and the ability to use the mass media for efficient advertising. The license agreement gives the franchise system a mechanism for standardizing its products or services, incentives for growth, and barriers to entry. All three parties to the franchise system (franchisor, franchisee, and customer) benefit, which explains why franchising has become the most prevalent form of new business start-up. We will return to franchising in Chapter 10.

Minor Wedges

A number of other entry wedges are designated as minor because they can be classified under the three major categories. Four categories of minor wedges, each with several variations, include exploiting partial momentum, customer sponsorship, parent-company sponsorship, and government sponsorship. They can be seen as a way to obtain resources that the new venture can use to compete. Table 4.3 cross-references the major entry wedges with the minor ones. For example, we see that "tapping underutilized resources" can be part of either a new product/service wedge or a parallel wedge strategy.

Exploiting Partial Momentum. Sometimes the entrepreneur already has sufficient market and product information to indicate that the new venture will be successful. This information acts as the impetus for the launch. The entrepreneur can exploit this existing momentum in three ways: by geographic transfer, by filling a supply shortage, or by putting an underutilized resource to work. A **geographic transfer** occurs when a business that works in one area is started in another. For example, Miho Inagi has opened a bagel bakery and store in Tokyo. She first learned about bagels as a student in New York. She took a job at Ess-a-Bagel (translation: Eat a Bagel) where she learned the business from the floor (sweeping) up (baking). But would Japanese eat hard bread? Most Japanese bakeries focus on soft-bread items and quasi-bread and cake concoctions. Inagi has made few concessions to Japanese tastes, offering mostly traditional, New York-style bagels. Her father (who later helped finance the business) lamented that, "We must have

TABLE 4.3 Major and Minor Entry Wedges

Minor Entry Wedges	Major Entry Wedges		
	New Product/ Service	Parallel Competition	Franchising System
Exploiting partial momentum			
1. Geographic transfer			X
2. Supply shortages		X	
3. Tapping underutilized resources	X	X	
4. Creating or modifying existing channels	X	X	
Customer sponsorship			
5. Customer contract		X	
6. Second sourcing		X	
Parent-company sponsorship			
7. Joint venture	X		
8. Licensing		X	
9. Market relinquishment		X	
10. Spin-off	X		
Government sponsorship			
11. Favored purchasing		X	
12. Rule change	X		
13. Direct assistance	X	X	

SOURCE: Adapted from K. Vesper, New Venture Strategies (Upper Saddle River, NJ: Prentice-Hall, 1980).

done a bad job raising you." But Inagi persisted and opened her business, Maruichi Bagel, in August 2004. After a slow start, the store now draws crowds and Inagi makes a modest profit.[12]

Entrepreneurs can launch new ventures by filling market gaps such as **supply shortages**. Sometimes the product or service in short supply must be physically transferred from one area to another. In this case, filling the supply shortage resembles geographic transfer in that the entrepreneur organizes resources to fill a shortage within an area. For example, recent trends indicate that for various tasks at varying times of the year, many firms prefer to hire temporary workers rather than full-time employees. However, there is a shortage of people available for temporary positions because most people prefer to work full time if they can. New ventures have been developed that specialize in personnel services for temporaries. These firms, like Professional Employer Organizations (see www.peo.com), organize the resource that is in short supply (temps) to meet market demand. They also meet the demands of the temporary personnel by scheduling additional work after each temporary assignment expires. For the firm, the shortage is relieved; for the personnel, there is full-time work (in various temporary assignments).

An **underutilized resource** is one with an economic value that is not recognized or one that is not being used to its best advantage. Often people are the most underutilized resource. Hence, entrepreneurs who can more fully realize other people's economic value are considered leaders. The underutilized resource can also be physical, financial, reputational, technological, or organizational. For example, entrepreneurs in the financial sector find ways to better use nonperforming financial assets, such as cash or bonds. Entrepreneurs have helped large organizations with strong positive reputations (for example, Disney and Coca-Cola) gain additional income by licensing their brand names, trademarks, and copyrights. Underutilized physical resources are often somebody's junk, waste, by-product, or worn-out product. These resources constitute the core of the recycling and remanufacturing industries. For example, entrepreneurs are building businesses by finding new uses for the mountains of worn-out tires dumped across the United States. Others are building vending machines that take in aluminum cans for recycling and dispense store and manufacturers' coupons.

Creating or modifying existing distribution channels enables the new venture to take advantage of the momentum that already exists in the value chain. For example, if strong production or inbound logistical areas already exist, finding new channels helps the entrepreneur to reach new markets. Many longtime successful catalog sellers, such as Lands' End, now use their Web sites as surrogate catalogs. They still do most of their business by mail order, but the Web is a new channel for them.

Customer Sponsorship. A new venture's launch may depend on the momentum supplied by the firm's first customers. A customer can encourage an entrepreneur in either of two ways. A **customer contract** can guarantee the new firm sales, and help it obtain its initial financing. Because the customer is not assumed to have altruistic motives, the entrepreneur should seek to expand the customer base once the venture is up and running. Sometimes, customers encourage entrepreneurs to become a **second source**. If the customer has previously had difficulty working with a single supplier, good purchasing practice would suggest that the customer rebid the contract. However, a good alternative for obtaining the product or service is not always available. When this is the case, the customer can encourage and even provide assistance (managerial, technical, and financial) to the entrepreneur who can satisfy the customer's needs. Both customer contract and second-source sponsorships generally lead the firm to use parallel competition as its major wedge.

Parent Company Sponsorship. A parent company can help launch a new venture in four ways. Two of these methods require ongoing parent-company relationships: **licensing** and **joint venturing**. The other two methods may continue the parent–new venture relationship, but are optional: **market relinquishment** and the **spin-off**.

Under a licensing agreement, the entrepreneur contracts with the parent company to produce a product or service or to employ a system or technology. The connection between the entrepreneur and the parent provides momentum for the new venture, because the founders have previous organizational experience with the parent as well as technical experience with the product or technology. The joint venture differs from the licensing format in two significant ways: (1) Resources are commingled when the joint venture is formed, and (2) Ownership rights in a joint venture require negotiation. These differences make the joint venture more difficult to manage, but the benefits of having two (or more) organizational parents can outweigh the cost.

For example, if we wanted to create an Internet business that used Java software, we would license the software from Sun Microsystems, Inc.[13] There would be no need for a joint venture with Sun because all the details of the relationship between the venture and Sun could be handled in the legal document. However, when the major automobile companies wanted to create a common application, using Java, for credit for a car loan, they formed a new company, RouteOne LLC. This company was formed as a joint venture.[14]

Market relinquishment means that the parent company decides to stop serving a market or producing a product. Although its motivation can vary, the parent usually makes such a decision because the firm is not cost-efficient. This is especially likely to be true if the product volume or market niche is small, for a large company's overhead can be high enough to make a small niche unprofitable. However, such a niche may be profitable for a small firm. The most likely candidates to start that small firm are the large firm's former managers of that product/market niche. Therefore, when the larger corporation relinquishes the market, the former managers may have the opportunity to purchase the larger firm's specialized assets and continue in their jobs, but this time as owner/managers instead of simply managers, thus providing the new venture with strong momentum. The change may not be visible to customers and suppliers, but the new firm can be much more profitable (and perhaps strategically more flexible) when it does not have to support the corporate bureaucracy.

One of the most common starting points for new venture creation (based on previously acquired knowledge) is the spin-off. A spin-off is a new firm created by a person or persons leaving an existing firm and starting a new firm in the same industry. The most frequent examples of spin-offs today are in high-tech businesses—biotechnology and life sciences, semiconductors and computers, consulting, law, and medicine (and medical devices). What do these diverse industries have in common? Both emerging and growing industries are prime breeding grounds for spin-offs. In these industries, pockets of information possessed by employees can be disseminated throughout the market. This information is mobile; it is embodied not in a machine or particular location but in individuals, a process, or a technique. Both the knowledge and the individuals can be transferred at very low cost to just about any place on earth.

Government Sponsorship. In Chapter 3, we discussed the impediments and constraints that government often imposes on new ventures. However, the government can also act as a sponsor for new ventures and provide entrepreneurs with launch momentum in the following ways.

1. *Direct assistance.* "They're from the government, how can they help you?" A number of local, state, and federally supported programs can aid the entrepreneur in starting or managing a new business. Most provide managerial or technical assistance; a few, like the Small Business Administration, may also on occasion provide financial assistance. One of the less well-known sources of technical assistance is the federal research laboratory system. At these labs, such as the Oak Ridge National Laboratory in Oak Ridge, Tennessee, scientists and engineers help businesses solve difficult technical problems. Other federal agencies have started programs to help small- and medium-sized businesses. NASA offers free consulting advice in cooperation with state agencies in Tennessee, Mississippi, and Louisiana. The Sandia National Laboratory in Albuquerque, New Mexico, also has a program.[15]
2. *Favored purchasing.* Favored-purchasing rules enable some firms to enter the marketplace with an edge. The federal government's own procurement policies often mandate set-asides and quotas for small businesses, minority and woman-owned firms, and firms started and managed by physically disabled people and veterans of the armed services. Many of these favored-purchasing rules have also been incorporated into procurement policies and practices at other government levels and throughout corporate America.
3. *Rule changes.* As government regulatory practices change and as new laws are implemented, opportunities for new firms arise. One of the most significant areas in terms of changes in government policy in the last decade has been privatization. Over the years, governments frequently found themselves in the business of providing goods and services to people. These have ranged from the provision of rail service to the running of hotels on government-protected lands. Of course, in former communist countries where the government owned all the means of production, privatization has been the way in which these assets have shifted to the hands of entrepreneurs. Even as we begin the twenty-first century, privatization opportunities abound for the sharp-eyed and quick-moving entrepreneur.[16]

RESOURCE-BASED STRATEGIES

How can our resource-based theory help us to create entrepreneurial strategy? We have already discussed the fundamentals of competitive strategy in terms of our resource-based theory. Briefly, resource-based theory says that for firms to have a sustainable competitive advantage, they must possess resources and capabilities that are rare, valuable, hard to copy, and nonsubstitutable (with resources that are neither rare nor valuable). One way of thinking about this issue is from the **payments perspective.** Each resource employed by the firm in the design, manufacture, and delivery of every product must earn a return or a payment. These payments are the rents on the resources. The total payments earned by the firm's resources are equal to its total revenue. The enemies of value and scarcity are imitation and substitution. Therefore, the critical strategy is the coupling of entrepreneurship and isolating mechanisms (see below).[17]

Rent-Seeking Strategies

Strategy in the resource-based framework is rent seeking.[18] There are five types of rents, and the strategies available to obtain them are different. Firms can attempt to capture more than one type of rent simultaneously. The five types of rents are as follows:

- **Ricardian rent**: These are rents derived from acquiring, owning, and controlling a scarce and valuable resource. They are most often derived from ownership of land or natural resources or from a preferred location. These types of rent can be collected as long as ownership and control exist, possibly in perpetuity.
- **Monopoly rent:** These are rents collected from government protection, collusive agreements, or structural entry barriers. Examples of government protection include patents and copyrights, restrictive licenses, and government-granted franchises. Many collusive practices such as price fixing and conspiracies in restraint of trade are illegal in the United States, but enforcement varies by time and place.
- **Entrepreneurial rent:** These are rents accrued from risk-taking behavior or insights into complex and uncertain environments. This type of rent is also known as "Schumpeterian rent," and is the type most closely associated with new venture creation. Schumpeterian rents are not as long-lasting as Ricardian and monopoly rents because of the eventual diffusion of knowledge and competing firms' entry into the market.
- **Quasi-rent:** These are rents earned by using firm-specific assets in a manner that other firms cannot copy. These rents are often based on idiosyncratic capital and dedicated assets. They are derived from a distinctive competence in how to use the resource as opposed to mere control of that resource. These rents can be collected by discovering or estimating the value of combinations of resources. The combinations are more difficult to price than stand-alone resources and therefore add value. The most important implication here is that it is possible to capture value in a tradable, scarce but not unique resource due to complementarities, asymmetrical information, or simply high levels of bargaining skill.[19]
- **Relational rents:** These are rents earned by cooperative-type strategies and interorganizational relationships.[20] They are somewhat similar to quasi-rents but they require that the venture work with another company. These rents may be a result of (1) relationship-specific assets, such as site specificity (co-location); (2) knowledge-sharing routines, such as technology-transfer agreements; (3) complementary resources that are not available or are priced in factor markets; or (4) effective governance, which minimizes transaction costs among organizations.

Resource-based strategies are geared toward rent-seeking behavior. The most prevalent of the five rent-seeking behaviors is the entrepreneurial strategy. Here a firm enters with a new resource configuration or implementation strategy and makes above-average profits until, through technological diffusion and increased knowledge, competitors are able to enter and compete away those profits. This describes the cycle of "destructive capitalism" that constantly redeploys capital to its most economic use.

Ventures with the four attributes required for sustainable competitive advantage are positioned to use strategy to collect one or more of the five types of rents. The more types of rent the firm can accumulate, the better its overall long-term performance will be. Any of the five types of rent described above require that the firm be able to protect its advantage. These protective devices are called *isolating mechanisms*. The absence of isolating mechanisms means that others (workers, investors, customers, competitors, governments) can work out strategies to claim the rents for themselves.

ISOLATING MECHANISMS AND FIRST-MOVER AVANTAGES

An entrepreneur who is fortunate enough to create a new venture must expect that competitors will attempt to retaliate, and protect his or her own positions.[21] Therefore, it is important that the entrepreneur find ways to increase these benefits and cash flows for either future investment or personal incentives. The methods the entrepreneur uses to prevent the rents generated from the new venture leaking out are known as **isolating mechanisms**.

Types of Isolating Mechanisms

Isolating mechanisms can take a number of forms. Most obvious are **property rights**, which consist of patents, trademarks, and copyrights. Any secrets, proprietary information, or proprietary technology also help isolate the firm from competitive attack. These mechanisms, though, will not last indefinitely; therefore, the entrepreneur must be prepared to move quickly and establish a strong position. Some firms establish their position, and work to protect it right from the beginning of the new venture. This is known as **first-mover advantage (FMA)**. First-mover advantage can also be a powerful isolating mechanism when combined with a government rule change that encourages privatization or industry deregulation.[22]

Sources of First-Mover Advantage

First-mover advantages prevent the erosion of the new venture's competitive advantage.[23i] A firm's resources and capabilities are frequently enhanced by its early entry. Examples include:

- Having prime physical locations
- Having technological space
- Having customer perceptual space
- Having an industry with standard setting
- Developing switching costs
- Generating lead time and learning

The first use of a technology, known as **technological leadership**, can provide first-mover advantages. The first mover in a particular technology can, of course, obtain the initial patents, but these are seldom decisive.[24] More important, the first mover builds up a research and development base that can lead to further innovations and improvements, thus keeping the venture ahead of the pack. As production (either *through* the new technology or *of* the new technology) increases, the learning curve is pushed ahead of that of competitors, often conferring cost advantages and economies of scale that can preempt or delay competition. Being the first mover may mean obtaining valuable and scarce resources ahead of others. It may mean getting rights to natural resources, securing the best locations, or crowding distribution channels (distribution space is a valuable and rare resource).[25]

The final source of first-mover advantage is the imposition of switching costs on buyers.[26i] **Switching costs** can be developed through marketing or contractual obligations. When a new venture creates brand loyalty through effective advertising, high buyer learning and evaluation costs, or complementary products, the firm makes it difficult for others to compete away its profit.

To be first, ventures need to be organized for speed and develop the capability to innovate and get to market quickly. Street Story 4.2 provides some examples of these fast-moving companies and some rules for organizing.

First-mover advantages can also be a disadvantage in certain situations. In some cases, the first mover must reveal the underlying business concept, and others may copy this by using different resource combinations. The first mover invests in resolving the technological and production problems that accompany any new venture. Other firms can then benefit from these investments. Also, being first once does not guarantee that the firm will always be first. Indeed, inertia can make the successful first mover resist abandoning a strategy when it is no longer effective. There are no simple prescriptions about first-mover advantages and disadvantages. The magnitude of the first-mover effect varies greatly and will dissipate over time. Later entrants sometimes catch up through advertising and pricing strategies.[27]

Growth Strategies

So far, we have seen how new ventures enter using their wedges, and how they seek to collect rents based on their capabilities and resources. We can also use our resource-based model to account for the rate and direction of a venture’s growth strategies. Firms grow in the direction of underutilized resources and toward their areas of expertise. The rate of growth is a step function, not a smooth path, because resources are usually employable only in bulky, discrete increments.[28] Basically, a firm’s growth is limited to its resources. Resources determine the industry the firm will enter and the levels of profit it can attain. For example, labor shortages, insufficient access to capital, and technological barriers all limit growth.

In the long run, however, the most important limit of all may be the scarcity of management capacity. There are two demands on managerial capacity: (1) to run the firm at its current size, and (2) to expand and grow. Current managers recruit new managers to increase the growth potential of the venture. However, these new managers need to be trained and integrated into the firm’s current activities, which takes time away from existing managers. While incorporating these new managers, the firm’s growth slows.

STREET STORY 4.2

The Fast Track to Profits

It used to take the Nissan Motor Company 21 months to develop a new car model; now they've got it down to half that time. It once took manufacturers like Motorola and Nokia 12 to 18 months to produce a new cell-phone model. Now they do it in six to nine months. AMR Research consultant Bruce Richardson has a terse explanation: "There are two kinds of businesses: the quick and the dead."

Atlanta-based casual food franchiser, Raving Brands, has launched seven different restaurant concepts, including Moe's Southwest Grille and Mama Fu's Asian House, in the past five years. The company doesn't have a central office; its senior directors meet every Monday at a Raving Brand restaurant to solve problems and discuss new ideas, including ideas that come from other restaurants. This get-down-to-business approach has enabled the company to translate ideas from concept to restaurant opening in one year as opposed to the two years needed by other franchisers. Raving Brands also jump-starts its expansion by hosting "tour days" in more than 15 target markets where company representatives present their different restaurant opportunities and meet with potential franchisees.

A speed advantage doesn't always come from the product itself. In 2004, wine producer, Jackson Enterprises, was able to come up with an innovative solution to a worldwide wine glut in just a few weeks. With the help of the product and service design firm IDEO, a team of Jackson employees quickly developed rough prototypes of two packaging concepts that were radically different from those of their traditional Kendall-Jackson brand, including wine in a cardboard container that looked like an elegant perfume box, and wine poured into a screw-top bottle with a drawing of a silly dog on the label. "We absolutely broke all the unspoken rules," reported team leader Laura Kirk Lee. The wine maker also set up a temporary bottling plant in a parking lot tractor-trailer truck to get the products to market as quickly as possible. While the team's goal was to sell 10,000 cases of each wine concept, they actually sold more than 100,000 cases of both new ideas.

Consumer electronics and appliances have today devolved into a commodity competition based on low prices, which unfortunately means low profits for retailers. But one store has found a way to get a first-mover advantage.

According to Best Buy Company's Executive Vice-President Ron Boire, "We go upstream to find out what the suppliers are doing. It's about speed to market. We know what the customers are looking for, and we have a time advantage in getting it to them." The company meets regularly with tech start-ups in both Silicon Valley and Asia to spot new products it thinks might become best sellers. In 2005 these meetings led to the discovery of Sling Box, a device that allows customers to transfer programs from their home TV to a PC in a different location. The $250 item was a winner for Best Buy, especially since the company was able to stock Sling Box three months before most of its competitors.

When one of Best Buy's Geek Squad service-team members had an idea for a PC external disk drive inside its own protective case (an item that didn't exist at that time), the company was able to find a manufacturer and then place the item in its stores within 120 days. Best Buy is also experimenting with concept stores in a few markets. One concept is *studio d*, a store that combines the latest electronic gadgets with classes to show nontechies how to use them. Another concept is the *eq-life shop*, where customers can attend fitness classes and then purchase the latest fitness gear. If Best Buy succeeds in building customer loyalty through this product-with-training approach, the company may also have an innovative approach to building switching costs.

SOURCE: Adapted from Steve Hamm, with Ian Rowley, "Speed Demons," *Business Week Online*, March 27, 2006. Retrieved from the Web March 21, 2006. http://www.businessweek.com/prionl/magazine.content/06_13/b3977001.htm?chan=gl, and Best Buy: Also see "How To Break Out of Commodity Hell," *Business Week Online*, March 27, 2006. Retrieved from the Web March 21, 2006. http://www.businessweek.com/print/magazine.content/06_13/b3977007.htm?chan=gl, and www.raving-brand.com.

Once these managers have learned the venture's structure and systems, growth begins again. This implies that "management is both the accelerator and brake for the growth process."[29] This rubber-band process, called the Penrose effect after the theorist who first proposed it, suggests that fast growth in one period will be followed by slow growth in the next period (that is, there is a negative correlation between period growth rates).[30]

Quality as a Strategy

In Chapter 1, we introduced the concepts of quality. Considerable thought, energy, and money have been devoted to making quality a source of sustainable competitive advantage. Hundreds of articles and books have been written on the subject. A prestigious national contest, the Malcolm Baldridge National Quality Award (http://www.quality.nist.gov/), is held each year. Many states now have programs to help companies develop and improve their products' quality. Although the concept of total quality management (TQM) is not new, there are still many programs that emphasize customer satisfaction (user-based quality discussed in Chapter 1). To some, TQM is the number-one priority for the firm, and it has entered the language and curriculum of top-rated business schools.[31] Companies that promote TQM programs are themselves a fast-growing industry. Consultants sell "off-the-shelf" TQM programs based on some simple ideas that can be understood by using the analogy with playing golf:

- **Continuous improvement.** This is the process of setting higher standards for performance with each iteration of the quality cycle. In golf terms, yesterday someone shot a score of 112, so today he or she will try to shoot 111.[32]
- **Benchmarking.** This means identifying and imitating the best in the world at specific tasks and functions. If one believes that Tiger Woods has the best swing, he or she tries to swing like Tiger.
- **Quality circle.** This is a loop of activities that includes planning, doing, checking, and acting. Keep one's head down, keep one's eye on the ball, and don't press. Now, where did it go?
- **Outsourcing.** This means procuring top quality from outside the organization if the firm cannot produce it from within. If she can't hit this shot, can somebody else hit it for her?

The resource-based approach calls into question the efficacy of these quality programs for long-term competitive advantage. If any firm can buy the principles of TQM off the street (so to speak), then it is not rare. Benchmarking, which is neither more nor less than copying, is by definition able to be copied. Outsourcing products from the best-quality vendors is both substitutable by producing in-house, or sourcing from other best-quality vendors. Can TQM be an effective strategy for sustainable competitive advantage? Research indicates that TQM programs are not magic formulas.[33] At best, they were termed a "partial success." The following were among reseachers' general conclusions regarding TQM:

- Copying other firms may mean expending time and money on the wrong things.
- Adopting a TQM program, under certain conditions, can actually make things worse because the program is so disruptive.
- Failing to link the TQM program with bottom-line results may ensue.
- Benchmarking is not effective unless the company already has a comprehensive quality program.
- Lower-performing firms should adopt TQM programs gradually; middle performers are better able to begin full-scale adoption; and high performers benefit the most from TQM.

INFORMATION RULES STRATEGIES

With the advent and popularity of e-commerce, many pundits claimed that the old ways of doing business had ended and the laws of economics should be rewritten. But two economists from the University of California at Berkeley did not see it that way. Carl Shapiro and Hal Varian believed that the same principles of economics that applied to the real world of business also apply to the virtual world of business. To establish their point, they wrote a book called *Information Rules: A Strategic Guide to the Network Economy*.[34] This discussion draws heavily on their ideas. We can see what their emphasis and focus are by going to their Web site: http://www.inforules.com/. The site demonstrates that these authors practice what they preach when it comes to offering a digital information product.

The electronic entrepreneur deals with **information**. Information is anything that can be put into a digital format, for example, photographs, text, catalogs, data, movies, stock quotes, and online MBA classes. Information is intellectual property and can be protected using copyrights, trademarks, or business-method patents. Finally, information must be experienced for people to determine its quality and benefits. People usually require a peek or preview before they purchase. Information can be very expensive to generate, but it is almost costless to reproduce. Therefore, selling information provides great margins—unless it is reproduced and re-sold by others. Information also has different uses for different people. Different versions of information can be offered to different customer segments. By segmenting the market, an entrepreneur can extract maximum value—the most profit from his or her property. E-businesses have many value drivers or ways of creating value through their operations and strategies (see Table 4.1 above). All of these facts about information are embodied in the strategies of e-entrepreneurs.

There are a number of key strategic options that e-entrepreneurs need to consider as they form their businesses and marshal resources and capabilities for their firms.

Value Pricing. Value-pricing strategy is based on the fact that different people value information to different degrees. What pricing strategy should we employ? If we are able to differentiate our product, we can attempt to sell information to each customer for a different price, depending on what the customer can bear. If we cannot differentiate and our information has become a commodity, we can be aggressive but not greedy, as the customer can likely get the same information elsewhere at a better price. We must remember that the information is almost costless to duplicate, and results in large economies of scale. We should also consider offering group sales, as the cost of selling data or information to a group is probably the same as the cost of selling it to a single individual. This strategy is the basis for site licenses for software products.

Versioning. This strategy means producing information in many forms for the customer. Some possibilities are:

- Delay. Sell some information to customers who need it in a hurry and want fresh, up-to-the minute reports (like stock quotes). Sell another version in another format (e.g., a digest of monthly stock movements). Charge the most for the latest data.
- Convenience. This is related to delay. Make it easier for some customers to use the data, and charge them for this privilege.
- Speed of operation. This is also related to delay. Make some information accessible quickly and charge for this service. Make some customers wait for their versions and give them a discount for doing so.
- Image resolution. Some data can be displayed to ultimate effect through enhanced graphics. Charge extra for an enhanced graphics version and offer a version without enhanced graphics (like text only) at a discount.
- Features and functions. Make some versions of the product available with search capability, cross-referencing, and a full line of features and functions. Make other versions with certain functions disabled, and charge less for these versions. Many users will trade up for full functionality. Note that it costs the same to produce the two versions; the firm simply offers less information to the price-conscious consumer. For example, many students may purchase student versions of software such as Windows Office Suite or Bizplan. The student versions are actually the same as the full-feature versions, but with some functionality turned off.

Intellectual Property. Intellectual property strategy is intended to maximize the value of the intellectual property. Many businesspeople think this strategy is the same as one that maximizes the protection for the property. But this is not true. Indeed, carried to its extreme, the maximum protection for the property is not to sell it at all! As we can see from the controversial maximum-protection positions once taken by the film and music industries, we can offend our customers with too much protection. Customers sense that information wants to be free and shared, so we need a strategy that maximizes value, not protection. Because digital technology lowers production and distribution costs, we must be willing to pass these savings on to the consumer. How?

- Give away free samples.
- Offer low-cost versions purchased one at a time.

- Give away indexes, tables of contents, and some graphic images.
- Give away lower-quality product and information.
- Be willing to license use, and employ group sales.

There will always be customers who want the highest quality, the timeliest data, and the product with the fullest functionality, and the one that is easiest to use. These very demanding customers tell us what is most important to them. They help us locate the true value of the property. They are the core of successful intellectual property management.

Lock-in. This strategy keeps the customer loyal to the venture. It is essentially the same concept we discussed earlier under the heading of switching costs. A lock-in strategy raises switching costs for the customer. The entrepreneur who can design a lock-in strategy and engender brand loyalty has the ability to maintain a relatively high price for the product. Further, this strategy reduces the cost of keeping current customers. Table 4.4 offers lock-in strategies and switching cost models.

Network Strategy. This strategy is based on the principle that one telephone is useless, but a million are very useful. The first fax machine was just a toy, but with two such machines, there is communication. A network with a great many users is significant because the more users there are, the more valuable it becomes for any single individual to be a part of that network. We see these principles applied in such successful businesses as eBay (http://ebay.com), Amazon (www.amazon.com), and the Japanese cellular phone company, DoCoMo (http://www.nttdocomo.com). If we find ourselves in a network of this type, it is vital that we recognize this fact. If we are in a network, we must take advantage of the **positive feedback** that exists within that network. If we do not do so, we will incur a large opportunity cost. If competitors take advantage of the positive effects and we do not, we might not survive.

A good example of pure network effects is instant messaging. The more people that are in a particular instant message network, the better it is for all the members. They can have extended buddy lists and contacts. The instant messaging firms compete to have the largest networks.

Cooperation and **Compatibility** Strategy. Many times entrepreneurs try to steer their firms' strategy in an adversarial "win-lose" fashion. But in the digital economy, this strategy is frequently wrong. The entrepreneurial team needs to determine which other firms may be part of its network, actual or potential. Then the team needs to cooperate with these firms to build the size and strength of the network. Often this means making products and technology compatible with each other. The goal is to have the network's standards become the industry standard. Doing so will create a "winner-take-all" situation, and if the network becomes the industry standard, that network wins.

A related way of thinking about how e-businesses create value is to look again at the **drivers** within this type of business. Four drivers emerge: **efficiency, novelty**, **complementarities** and (the now-familiar) **lock-in**.[35]

Some of the value that is created by an e-business results from the use of efficiencies—

TABLE 4.4 Lock-In and Switching Costs for Customers

Types of lock-in	*Switching costs*
Contracts and subscriptions	Damages for breaking the contract or ending the subscription before it expires
Durable purchases	Replacement of the equipment; switching cost declines as equipment ages
Brand-specific training	Customers have to learn a new system, process or technique; loss of productivity during training period
Information and databases	Data conversion costs, potential for losing data; larger databases equal higher costs of conversion
Specialized suppliers	Search of finding new supplier; new supplier may not have precisely the same capabilities and quality of older supplier
Search costs	Aggregate of buyer and seller costs
Loyalty programs	Lost benefits from program; need to start over with another company's program

reducing the costs of searching, transacting, monitoring, and decision making. These are real costs to the consumer and the consumer will pay to have them reduced or eliminated. In theory, as each consumer might have a different set of costs, a new version of the product or e-business Web site can be created for each consumer.

Novelty is created by bundling the features and benefits of the e-businesses' products and services. Each product or service can have an element of difference or novelty, but even if the product or service lacks such novelty, the bundle can be novel or unique in some way. Because every customer (in theory) will want a different bundle, this type of customization is a value driver.

The value driver, complementarity, is a function of the bundles, but may go further. It may refer to the complementarities of partners or technologies, and include the network effects of complementarity of customers and vendors.

Last, Amit and Zott include the concept of lock-in, which is similar to previous descriptions including brand loyalty, loyalty programs, and dominant technology.

STRATEGY AND INDUSTRY ENVIRONMENTS

Not all ventures enter the same industry. How much difference does the industry itself make in determining strategy? The answer is, "quite a lot." Entrepreneurs can significantly add to the success of their strategies by understanding the industry environment they are entering. A static description of industry structure was presented in Chapter 3. However, industry environments are static only in the short term; over a longer period of time they evolve. This evolution is called the **industry life cycle**. The industry life cycle progresses through four stages: emerging, transitional, maturing, and declining.

The industry life-cycle progression is not the same for all industries. The length of each stage and the timing of the stages are highly variable and difficult to predict. The same is true for product and organizational life cycles. Entry and competition take on different forms, depending on the stage of the life cycle.[36] Figure 4.2 presents a diagram of the industry life cycle. It follows the familiar s-curve of many economic phenomena.[37] The shape of the curve shows that emerging industries are characterized by increasing rates of growth. Transition occurs as growth continues at decreasing rates. In the mature stage, growth rates approach zero. A declining industry is characterized by no growth or negative growth rates, whether measured in total units of production or in dollars.

Emerging Industries

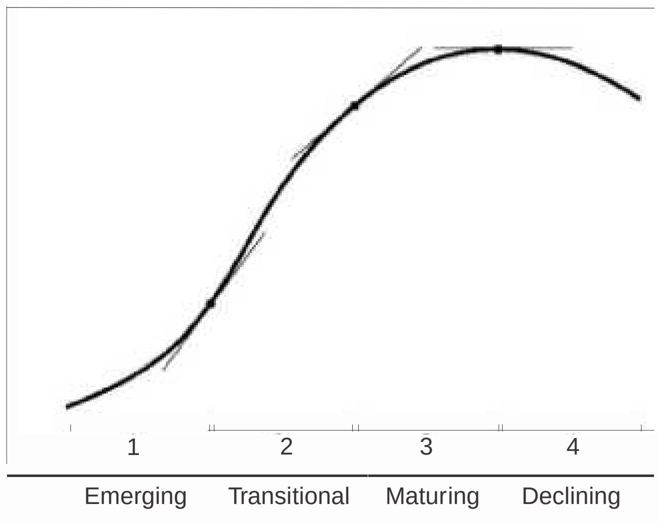
Emerging industries are the newly created networks of firms launched to exploit a new technology, a new market configuration or set of customer needs, or other changes in the macroenvironment.[38] Emerging industries experience high levels of uncertainty, rapid change, and a growing number of organizations (high rates of births). Recent examples of emerging industries are biotechnology and life sciences, the electric automobile industry, products for use on cellular telephones, and the interactive television industry.

Individual firms and entrepreneurs can create or reconfigure entire industries through vision, creativity, and innovation. An innovation strategy can create a customer where none previously existed.[39] How can this be done?

- *By creating utility.* The entrepreneur can change something that is hard for people to do into something that is easy for people to do. For example, there had been "mail" since Roman times, but the mail industry arose with the creation of a postal service in Great Britain, making it easier for people to pay for and send a letter.
- *By creating value.* The entrepreneur can change something that was expensive into something that is inexpensive, and thereby create value through creative pricing. King Gillette did so when he unbundled the razor from the razor blade. Xerox did so when it realized it did not have to sell copiers, just the use of the copiers. It changed a relatively large capital-investment decision into a small operating expense to gain acceptance.
- *By changing the customer's reality.* The entrepreneur can help customers buy products through creative distribution and financing, and help customers use products by simplifying operation and providing training. Entrepreneurs help customers solve problems by selling systems instead of products.

Structural Uncertainty. Even for ventures on the verge of revolutionizing the market, however, entry into emerging industries imposes certain structural conditions and constraints. The most imposing structural condition is uncertainty. There are no traditional ways of doing things, rules of thumb, standard operating procedures, or usual and customary practices. There is only the unknown future and the entrepreneur's will to succeed. Technological uncertainty means that the final configuration of resources, especially technological resources, is still unsettled. Firms, like laboratories, are trying new com-

FIGURE 4.2 The Industry Life-Cycle Curve



binations of technology, human resources, and organizational systems to discover what works. Successful combinations are adopted by other firms as fundamental, and further experiments are conducted to refine the concepts and practices. Usually a single standard emerges for all firms. Occasionally, two competing standards reach the public at the same time as, for example, video technologies like Beta and VHS. But only one survives.

Strategic Uncertainty. Emerging firms also face a great deal of strategic uncertainty. New ventures in emerging industries are often unaware of who the competition is (or will be), what types of products and processes the competition is working on, and what posture the government will take toward the new industry. Because birth rates are high, new firms are springing up all the time, making it difficult to keep track of who and what they are. Government regulatory agencies at all levels are slow and bureaucratic. They are unlikely to have existing rules to help guide the new ventures.

Resource Uncertainty. Additional uncertainty looms in the firm's input markets. It is often difficult for the new venture to raise capital, because financial sources are unfamiliar with the new industry's risk/reward profile. Although some venture capital firms specialize in supporting investments in emerging industries, most financial institutions shy away from them. Labor is another input that is difficult to procure, especially managerial talent. Managers and executives face a great deal of career risk and economic uncertainty when joining firms in emerging industries. Turnover may be high in an unstable and turbulent industry. Managers and executives may need to be as entrepreneurial as the founders in order to meet the challenge of a new venture in a new industry.

The procurement of raw materials, supplies, and parts may also be difficult during the industry's emergence. If these inputs are also employed by other industries, there may be shortages until the vendors can adjust their capacity. If the inputs are newly created, developed, or engineered, they may be of uneven quality *and* in short supply. In either event, input costs are likely to be at their highest during the emergence stage.

Customer Uncertainty. Uncertainty also plagues the output (customer) market. To a large extent, the customer market is only vaguely understood: buyer needs and wants, income levels, demographic characteristics, psychographic profiles, and buyer behavior characteristics. Prices and the points at which customers will resist high prices are uncertain. There may be quite a bit of instability as firms, producing widely diverse and nonstandard products, come to market with different and nonstandard prices. The customer is also confused by the variety of product offerings, the lack of standardization, the perception of rapid obsolescence, and the erratic quality of some competitors.

Controlling Uncertainty. In the face of difficult structural conditions and constraints, what must the new venture in an emerging industry do to be successful?

> *Look toward developing, generating, acquiring, and controlling resources that have the four attributes (rare, valuable, hard to copy, nonsubstitutable) needed for sustainable competitive advantage.*

The priority in an emerging industry is to acquire resources. Ventures that acquire resources early are more likely to set the rules and standards for industry competition, technological configuration, and product quality. Speeding up decision making, product development and introduction, and organizational systems and processes all have positive effects on firm survival and performance.[40] One industry that is attempting to speed itself up and that represents a typical emerging industry in its early stages is superconductive materials.

The next priority is to employ resources to gain a defendable foothold in the industry on which to build. The early acquisition of a core group of loyal customers is a major accomplishment. It enables the firm to develop experience in production and marketing, evaluate new products and alternative pricing schemes, and provide steady cash flow. From this base, expansion is possible.

Last, because knowledge and information can possess the four attributes of SCA, the new venture must move as quickly as possible to develop an intelligence network to forecast future environmental trends, competitive moves, and technological developments.[41] The initial turbulence and change that made the formation of a new industry possible are not likely to subside once a handful of early new entrants has formed. The turbulence may continue unabated, often for years. While the new entrants sort out the standards, later entrants make their appearance and attempt to capitalize on the efforts of the first movers. Older and larger firms attempt to invigorate their operations by entering new markets or forming joint ventures. Regulators, organized labor, and the government conspire to appropriate and tax the "profits" of new ventures. These so-called profits are in reality the early excess returns, which the founders may need for reinvestment to recoup the firm's up-front investment, encourage future investment, and maintain its technological or marketing advantages. Taxes and other appropriations leave the firm and, in aggregate, the industry underinvested and therefore smaller than it otherwise might have been. The result, of course, is diminished output, innovation, and employment. When this problem is recognized by policy makers, protection can be authorized, such as patent rights, tax abatements and credits, and accelerated depreciation schedules. An intelligence system may not be able to stop these trends, but a forewarned firm is in a good position to protect its assets.

Transitional Industries

Transitional industries—those moving from emergence to stability—have certain recognizable features. At some point, they will experience scarce resources, changes in customer tastes and values, and, finally, a shakeout. The shakeout period is crucial, for many firms go out of business at this time. The new venture can anticipate these developments, although their precise timing is always problematic.

Scarcity of Resources. As new firms enter the industry with an often dazzling array of products, strategies, and configurations, two powerful forces are at work. First, these firms bid up the prices of the resources they need to get started. Physical resources increase in price as they become scarcer. Scientific and managerial expertise costs more as people are lured away from current jobs with higher salaries and perquisites. Financial resources become more expensive as venture capitalists and investors demand higher yields from the later entrants. Overall industry costs rise as demand for industry inputs rises.

Customer Changes. The second force is the changing nature of the output market. Customers become more sophisticated and sure of what they want in terms of value, quality, and product characteristics. They become more powerful as they become more knowledgeable; they have more choices than they had earlier in the industry life cycle; and they are more likely to shop on price. The uncertainty of not knowing who the customer is and how large the market may be starts to fade as experience tells businesses who will buy and who will not. Competition for the existing customer base intensifies. Growth slows at the same time that shoppers become more price sensitive.

Survival Strategies in the Shakeout. What is the result of increasing production costs and decreasing selling prices? Smaller margins for everyone. Only the efficient survive. This is the transition phase, also known as the **shakeout**. Firms whose costs are too high will be forced out of business.[42] Firms that survive will be those that have resources with the four attributes of sustainable competitive advantage. When assets that are rare, valuable, hard to copy, and nonsubstitutable are deployed, the venture will be able to withstand price pressure and/or maintain lower costs than competitors.

The first priority in surviving the shakeout is to rationalize the resource base. This means pruning resources (of all six types) and the products or markets they serve if these resources are not earning rents and profits. During the emerging stage, firms often acquire excess resources, or slack. They do this for two reasons: (1) Because they are uncertain which resources will be the most important, they seek to gain control over as many as possible; and (2) Growth is difficult to absorb, and as resources build, it is not easy to reinvest or deploy them quickly enough. During the shakeout period, as growth slows and margins are squeezed, slack must be wrung from the venture to restore it to agile, lean, and flexible conditions.

The next priority is to get the most out of reputational and organizational resources. These are often the last to develop for the new venture. Reputation is slow to develop because it takes time for the market and other stakeholders to gain experience with the firm. The organization, with its systems, processes, and routines, is also often a late-developing resource; it tends to evolve as the business grows, experimenting along the way. The interaction among the people, work flow, and policies that constitute the organization also tends to evolve as the business grows. This interaction is complex. It takes time for all these components to come together. Even after the components have coalesced, it takes practice and therefore time before that system can be perfected.

Reputation and organization are two of the most difficult resources to copy. As technology becomes more diffuse, as financing becomes more available to entrants, and as physical resources evolve toward commodity-type inputs, reputation and organization (and, by implication, human resources) are the best defense against increased competition and rivalry.

Another potent strategy during the shakeout period is for the firm to buy cheap assets from the losers in the competitive game. As firms go out of business and their investors try to recoup whatever they can by selling the company or liquidating its assets, these assets often come to market at prices below their rent-earning capacity. The surviving firms, with superior human resources and organizational skills, can employ the liquidated physical resources, patent rights, licenses, and newly unemployed workers, managers, and staffers more effectively than their previous owners could. This firm-specific talent enables the survivor to collect a quasi-rent on the loser's former assets.

The strategy of expanding within the same business line by acquiring (by whatever method) other businesses is also known as **horizontal integration**. For example, horizontal integration and resource rationalization are the hallmarks of the shakeout in the biotechnology industry.

Shakeout Pitfalls. Firms must avoid pitfalls to survive this dangerous period. The most important of these is the "uniqueness paradox."[43] The paradox refers to a blind spot that many companies have, especially those that are still relatively young. The uniqueness paradox occurs when people attribute unique characteristics to their own organization, characteristics that are, paradoxically, possessed by many other organizations. Although internal cohesion may strengthen when organizational members differentiate themselves from their competitors by believing they are unique, this practice is bad for strategy. It is bad because it fools the firm into believing that some or all of its resources have the four attributes of SCA when, in fact, they do not. It makes the firm complacent and gives it a false sense of security. The firm is forced to react to outside pressures instead of generating its own proactive activities. The uniqueness paradox spells doom for the firm.

A second pitfall has already been mentioned—keeping slack and excess capacity. The only thing worse than holding onto unused resources and facilities with too much capacity is acquiring new capacity that provides no rent-collecting possibilities. But firms do make the mistake of trying to corner the market on physical capacity even as growth slows.

A final pitfall is simply failing to recognize that the industry environment has changed. Sometimes the founders have difficulty adjusting to these new realities, and the entrepreneur is forced out and succeeded by a less creative but more managerially efficient executive. This scenario is more probable when outside investors control the firm and fear that failure to act will cost them their investments.

Maturing Industries

It seems more appropriate to think of entrepreneurial strategies in the emerging and transitional environments because the most visible and publicized entrepreneurial activity takes place here. Entrepreneurs, though, are not limited by law, economics, or customers to these two phases of the industry life cycle. Entry can take a place in mature industries as well. Some flatly reject the idea that there is such a thing as a mature industry—there are only mature (and poorly run) firms. The argument is over the direction of causation. Does a maturing industry lower firm profitability, or does low firm profitability bring on the mature condition?[44]

Mature industries are characterized by slower growth, little pure innovation, more product and process improvements, more sophisticated customers, and an increasing concentration of producers.[45] The last characteristic means that a few firms may produce 40 percent to 80 percent of the goods and services in the industry. This increased concentration also means that one or two industry leaders have emerged. An industry leader is the one the others look to for price changes and strategic movements. Sometimes mature industries appear to be friendly "clubs" with minimum competition and a general understanding of how to compete. The U.S. auto industry, the beef packers, the television networks, and the beer brewers spend as much time cooperating with each other to fend off attacks from outsiders (the Japanese automakers, the pork lobby, cable TV operators, temperance societies) as they do competing against each other. Street Story 4.3 demonstrates that success in a mature industry can sometimes come from a new-product innovation or twist. It is a gut-wrenching tale.

However, entry is possible in mature industries, although the barriers are high. The computer hardware business is an example.[46] Start-up and entry in this industry are increasingly rare. The business is saturated. Ben Rosen, the venture capitalist who bankrolled Compaq Computer in 1982, says, "In terms of main-line, hard-core computer companies, it's very hard to define an area where you can get to a critical mass of $50 million to $100 million" in sales. Short of that size, the chances of an entrepreneur making big returns and taking the company public are slim. Veterans of the industry are sadly concluding that the heyday is over. "It may not be possible to start a new computer manufacturing company," laments Richard Shaffer, publisher of *Technologic Computer Newsletter.* There are other problems as well:

- Capital costs have soared. "It costs $50 million just to find out if anybody cares."
- Limits on technological innovation are being reached. Firms promising breakthroughs are often disappointed.
- Customers are ordering replacements slowly. Much computer machinery just doesn't wear out.
- The industry's move to standardized parts and operating systems limits the innovation small companies can provide.[47]

STREET STORY 4.3

A Gripping Experience

Inventor Dan Brown entered the maturing hand-tool market literally with a twist: He introduced a wrench-pliers hybrid with tiny jaws inside its circular head that grasps 16 different sizes of bolts or nuts evenly when you squeeze the tool's ergonomic handles. Known as the Bionic Wrench, this eight-inch tool saves handymen from bringing fixed-head wrenches in multiple sizes to every job, and is quicker to use than traditional adjustable wrenches. It's also particularly effective with nuts and bolts that are "stripped" or worn around the edges, user-friendly for people who don't have a lot of strength in their hands, and it works with both metric and standard-sized equipment.

Brown knows he has a good product. The Bionic Wrench was selected by *Popular Mechanics* magazine to receive its Editor's Choice award for outstanding achievement in new-product design at the 2005 National Hardware Show; it also won a 2006 International Forum Design Award in Germany and an International Industrial and Graphic Design Award from the Chicago Athenaeum.

But accolades may not carry enough weight for the Bionic Wrench to succeed. National retailer, Home Depot Inc., has declined to carry the product. Buyer Billy Bastek explains, "Hundreds and hundreds and hundreds of new products come across my desk every year, and that doesn't even include all the inquiries from our Web site." One factor turned Bastek against the product. "I thought the Bionic Wrench was somewhat of a neat item, but I didn't think it was priced particularly well, and that's kind of it." In contrast, the hand-tool buyer for Ace Hardware was eager to stock the Bionic Wrench in his 2,600 retailer-owned hardware cooperative stores, even at its $32.95 suggested retail price. "There are a handful of items to grab onto for the year, and we said, 'This might be one of them,' and we rolled the dice," says Dan Crane.

Bionic Wrench's price is high because the tool is manufactured in the United States. Brown could produce the item more cheaply by moving production to China, but he says, "I want to show this can be done in the States." Brown has also resisted making deals with chain stores like Sears and Lowe's to produce a version for their Craftsman or Kobalt private label, because he fears the chains would discount the retail price too much. Instead, he promotes the Bionic Wrench on his own Web site (www.loggerheadtools.com), under a slogan that promises "a gripping experience." He plans to introduce the wrench in six- and ten-inch sizes, in addition to offering a multi-purpose tool, a Bionic pipe cutter and three additional wrenches.

Bionic Wrench racked up sales of $800,000 in 2005. Now that the wrench is being carried not only by Ace Hardware but also by QVC, Hammacher Schlemmer, Canadian Tire Corporation, and other retailers, Brown hopes to reach a sales volume of $6 to $8 million in 2006. That's pretty good—even if it's not as good as the sales figure for the other guy named Dan Brown, the one who wrote *The DaVinci Code*.

SOURCE: Adapted from Gwendolyn Bounds, "Wrench Wins Awards, but Is It Priced Too High to Be a Hit?" *The Wall Street Journal*, March 21, 2006. Retrieved from the Web March 21, 2006. http://online.wsj.com/article_print.SB114289721659203443.html, and www.loggerheadtools.com

Attacking the Leader. One possible strategy is to attack the industry leader (an imposing task, but not impossible).[48] Industry leaders may become vulnerable when the business cycle is on the upswing and things look good; they may become complacent. Past performance success leads to strategic persistence (inflexibility) even when the environment changes radically.[49] Those industries with unhappy customers can also be attacked; they have grown arrogant and are no longer providing value. When leaders are under antitrust investigation, they are certainly less likely to retaliate, but even here it is never wise to attack an industry leader with an imitative, me-too product or service. The challenger who does so has nothing to defend.

Three conditions must be present for the attacker. First, it must have some basis for sustainable competitive advantage. Some resources must possess the four-attribute qualities that would provide the entrant either a cost advantage or a sustainable difference. Second, the new entrant must neutralize the leader's advantage by at least matching the perceived quality of the leader's product. Third, there must be an impediment (more than one is even better) that prevents retaliation. These impediments are:

- Antitrust problems
- A cash crunch caused by overextension
- A blind spot such as the uniqueness paradox
- An overdiversified portfolio, causing neglect of key areas
- A strategic bind (retaliation would jeopardize another business strategy)

If these three conditions are met, the new entrant has a chance. One tactic for success is to reconfigure the ways of doing business, that is, do something startlingly different. For example, the makers of Grey Poupon mustard reconfigured their marketing by spending more on advertising than the mustard business had ever done in the past. French's, Heinz, and others were forced to give up market share to this upstart.

A second tactic is to redefine the scope of service. A new entrant can focus on a particular niche, serve that customer exceedingly well, and gain a foothold in a mature industry. For example, La Quinta motels concentrated on the frequent business traveler on a small budget. There was little retaliation, lest entrenched competitors ruin their own pricing structure and demean the reputation of their core brands. Last, the challenger can attempt to spend its way to success. It can try to buy market share by offering exceptionally low prices and conducting heavy promotion and advertising. This is risky business and out of the reach of all but the best-financed entrepreneurs.

Specializing. One additional entrepreneurial strategy can be used to enter a mature market. This strategy requires that the new venture do something for a mature business better than the business can do for itself. New firms and small firms can thrive in a mature market if they can take over some specialized activities for a big concern.[50] It is not unusual for a highly specialized small firm to have lower operating costs than large firms. The larger, more mature firms carry more overhead, have older technology, and do not focus on the cost drivers the way a smaller firm can. For example, Ameriscribe operates mailrooms for National Steel; it does so better and more inexpensively than National Steel could. The Wyatt Company, a consulting firm, conducted a survey and found that 86 percent of the nation's largest corporations had cut back on operations and had contracted services to outsiders.

Declining Industries

Declining industries are characterized by end-of-unit sales growth and by flat, constant dollar sales (i.e., sales adjusted for inflation). Ultimately, both of these indicators decrease.[51] Current examples of consumer industries in decline in the United States are tobacco, dial-up services, and hard liquor. Industrial sectors in decline include manufacturers of carburetors for automobiles and producers of bias-ply tires for original equipment manufacturers (OEM). The primary causes of industry decline are technological substitution, shifts in the tastes and preferences of consumers, and demographic factors.

Technological Substitution. When an older technology is replaced by a newer one, the older technology goes into decline. However, it does not immediately disappear. Even after the invention and adoption of the transistor, which replaced vacuum tubes in radios, televisions, and other devices in the late 1950s and 1960s, producers of vacuum tubes continued to exist. They supplied replacement parts for existing sets and made products for the hobby and collector markets. Similarly, producers of vinyl, long-playing records still exist, although these have been rapidly and overwhelmingly overtaken by producers of compact discs and digital downloads.

A recent, but unsuccessful, attempt at entry in the declining newspaper industry illustrates technological substitution pitfalls. Dan Gilmour tried to reinvent journalism by creating Bayosphere. Bayosphere was a start-up that focused on local news. Gilmour's vision was to have armies of local people write their own news stories and blogs to produce coverage that no print newspaper could match. Print news has been in decline for many years and continues to lose advertising to the Web as well as circulation to other media. The Bayosphere venture failed because local newspapers also used the Web for local reporters, Web advertising didn't emerge, and the blog had low participation. The venture lasted only eight months.[52]

Changes in Tastes and Preferences. Changes in tastes and preferences result in demand shifting to alternative industries, but do not cause immediate extinction of the declining industry. The declining consumer industries noted previously reflect changing tastes. For example, the underlying trend today is toward healthier lifestyles. However, millions of Americans each year have a steak for dinner, accompanied by a whiskey and a cigarette after dessert. While the volume of these three products continues to be high, sales are decreasing a little each year.

Rhonda Kallman has entered two declining niches and done so successfully. She is a veteran of the beer wars and helped co-found Boston Beer (Sam Adams). More recently, she founded the New Century Brewing Company, which introduced the Edison brand. Edison is the only patented light beer and is sold at Trader Joe's grocery stores. Kallman also recently launched Moonshot—a beer with caffeine. Note how she found twists on consumer tastes to reinvigorate her products' images.[53]

Changes in Demographics. Changes in demographics are reflected in overall product demand (see Chapter 3). As the baby-boom generation made its way through the population cycle, its members first created a boom in children's clothing and furnishings, followed by a decline in these industries. They then bought automobiles and residential real estate, which mushroomed; now each of these industries is in decline. The boomers are aging, as are their parents, which makes health care the fastest-growing segment of the gross national product (GNP). Guess what will occur when the boomers start to die? Health care will decline, and the mortuary business will boom.

Achieving Success. Under certain conditions, new entrants can establish successful niches in declining industries. The key for the new entrant is to find ways to help the incumbents leave the industry and then purchase their assets at low prices. This is an imposing task, however, because a number of factors increase the height of the exit barriers for firms in declining industries. These factors are:

- the low liquidation value of specialized assets
- the interrelationship of the business in decline with other businesses not in decline
- the potentially negative effects of exiting on financial markets
- the emotional and managerial effects of calling it quits

From the viewpoint of the entrepreneur, an opportunity exists if an industry is still attractive and the entrepreneur has or is able to acquire resources with the attributes of sustainable competitive advantage.

Fragmented Industries

Figure 4.2 shows the life-cycle curve for an industry that has, over time, consolidated. *Consolidation* means that the number of firms decreases, the birth rate of new firms diminishes considerably, and larger firms have advantages of scale and scope. However, not all industries are dominated by large firms with megamarket shares. In other words, not all industries go through the life cycle depicted in Figure 4.2. Industries that do not are called **fragmented industries**. Examples include professional services, retailing, distribution services, wood and metal fabrication, and personal care businesses, such as hairdressers and barbers.

The causes for fragmentation are diverse. Low-entry barriers can cause fragmentation because firms will always be faced with new challengers and therefore be unable to grow. An industry may not be able to generate economies of scale, because being larger brings no cost advantages. In these cases, firms do not get larger, and consolidation never takes place. Indeed, there may be diseconomies of scale; costs go up (on a per-unit basis) as firms grow. High transportation and inventory costs may keep firms small and geographically limited.[54]

The effect of firm size on buyers and sellers also can keep an industry fragmented. If neither buyers nor sellers see advantages in dealing with larger firms, they will avoid such firms and negotiate with smaller, less powerful firms. Sometimes market niches are too small to support larger firms because market needs are so diverse. Any or all of these conditions can keep an industry from the path described in Figure 4.1 and hence keep the firms in the industry small and relatively powerless.

Most of what we understand to be the small business sector of the economy is actually the set of fragmented industries and the ventures within it. Businesses in fragmented industries can be profitable, and they can grow to be relatively large. But by definition, if they are large enough to have a market share that can influence conditions, the industry is no longer fragmented.

Overcoming Fragmentation. New ventures in fragmented industries sometimes have the potential to introduce strategic, technological, or managerial innovations that may help the industry overcome fragmentation. If the new venture enters with technologies that introduce economies of scale, the venture will grow larger. For example, the brewery industry used to be fragmented, with thousands of local brewers. The technological breakthrough that overcame this fragmentation was the refrigerated freight car, which enabled brewers to ship their beer long distances without danger of it spoiling.

Fragmentation may also be overcome by strategies that reconstruct the way firms operate. The sneaker used to be a fragmented product in the sporting goods industry. With few exceptions, it was sold as commodity footwear for kids (Keds, Converse). When it was reconstructed as an "athletic shoe," developed technologically, and promoted as a personal fashion statement, the result was a highly profitable industry dominated by a few very large firms (Nike, Reebok, Adidas).

Another method of reconstructing an industry is to separate the assets responsible for fragmentation from other assets. This is known as *unbundling.* Two classic examples of unbundling are campgrounds and fast food.[55] These industries are characterized by thousands of small owners. Both require tight local control and supervision and must be located near their customers, but significant economies of scale in purchasing and marketing were achieved through franchising. Local control was maintained by the franchisee, and purchasing and marketing economies were obtained by the franchisor. The initial beneficiaries of these economies were McDonald's and KOA.

Investors, and especially venture capitalists, are increasingly targeting fragmented industries as neglected but high-potential opportunities. Why? Because a firm that overcomes fragmentation can become the industry leader, achieve enormous size and profitability, and provide rates of return in the thousands of percent range. The Chicago firm of Golder, Thoma & Cressy is often credited with originating this investment strategy. So far, it has applied its strategy to the nursing home, answering service, and bottled water businesses. Other industries ripe for consolidation are small-niche food processors, small-town newspapers, security alarm companies, and (the ultimate local business) funeral homes.

The strategy is not easy to execute. First, the investor identifies and acquires a company in a fragmented industry, one with no market leader. Then a new management team is recruited to run the business. Together the investors and new managers identify and negotiate to buy a few additional companies in the target industry. The hardest part is next: consolidating all the companies under a common name and set of operating practices. If this strategy works, the payoffs are huge.[56]

Coping with Fragmentation. Quite often the new entrant lacks the resources, means, or imagination to overcome fragmentation. Excellent money can still be made, however, from high-quality implementation, and the firm that learns to cope with fragmentation can thrive. A solid and profitable small business can be built on the following foundations:

- *Regimented professional management.* The introduction of managerial techniques and professionalism into small-business operations can keep the firm profitable even under strong price pressure.
- *Formula facilities or franchising.* High degrees of standardization and efficient, low-cost operations provide protection against eroding margins.
- *Specialized niches.* A business that is highly specialized by product type, customer type, order type, or geographic area can achieve minor economies of scale and add high value for buyers.

Warning! A firm can be so specialized that it may not have enough customers to be viable. Do not plan to open a pen repair shop, a shoelace boutique, or a restaurant based on the concept of toast (although one based on breakfast cereal has apparently been founded).

CRAFTING AND EVALUATING STRATEGY

Amar Bhide, in his important article on how entrepreneurs craft strategy, noted that the most important elements for entrepreneurial success seem to be speed in seizing opportunities and eliminating unpromising ideas, a concentration on important issues, and the use of realistic and spontaneous actions that include changing course if necessary.[57] His recommendations are:

- Screen out losers quickly. In the crafting of strategy, entrepreneurs frequently must be very fast and agile because speed to market or to access resources can confer an advantage. This means the entrepreneur has little time for long, drawn-out data collection and analysis. Therefore, entrepreneurs must use a few basic rules that have worked well for them as individuals in the past. These rules enable them to be decisive.
- Focus on a few key issues. These issues will vary depending on the entrepreneur and the opportunity. If the opportunity is in retail, location will be a “go/no go” issue. If the opportunity is the manufacture of a new pharmaceutical, regulatory approval and licensing will be the key. The issues the entrepreneur should consider will all depend on the situation.
- Do not wait until all of the analysis is complete, and all the answers to the questions are known before getting started. The entrepreneur has to integrate action and analysis. In fact, it is not uncommon for entrepreneurs to do their market research by simply trying to find customers. If customers are found, these particular customers should be captured first. The information gathered in the action-research stage will be used as data to revise and reconfigure the opportunity. The data may indicate that some or all of the opportunity is not what it appeared to be in the early screening stage. If no customers are found, the entrepreneur should be prepared to change course.

Entrepreneurs who wish to take a more systematic and deliberate approach can break the process up into more discrete parts. Opportunity assessment has five different stages (see Figure 4.3). Each stage focuses on analysis and the actions that must be taken. Analysis rests on the entrepreneur's understanding of the nature of the business that he or she wishes to create. Traditionally, entrepreneurs must ask the question, What is my business? They then attempt to answer the question in terms of a target customer and the target's buying needs, tastes, and preferences. In a world with volatile markets and changing tastes and preferences, keeping up is a dicey proposition. So, in opportunity assessment, entrepreneurs should initially assess their core, stable set of *internal* capabilities rather than volatile external resources.

Stage 1: Identification

The first stage requires entrepreneurs to identify and classify the resources they currently have and can control in their initial efforts to create a new venture. Identification and classification should be structured using the six categories previously described: financial, physical, human, technological, reputational, and organizational assets. A resource is currently controlled if the entrepreneur and the top-management team have immediate and unimpeded access to it, legally and physically. An asset is controllable to the extent that it may be obtained sometime in the future. For a rigorous analysis, a probability distribution can be conducted that indicates the likelihood of obtaining the resource. If it is extremely high or low, this probability can be factored into the next part of the stage 1 assessment.

The second part of stage 1 entails determining the relative strengths and weaknesses of the resource bundle and configuration. The entrepreneur should then examine how to use these resources and explore what business opportunities exist to make the most of them. What criteria should the entrepreneur use for this evaluation? The four attribute criteria: Is the resource under investigation rare, valuable, hard to copy, and nonsubstitutable?

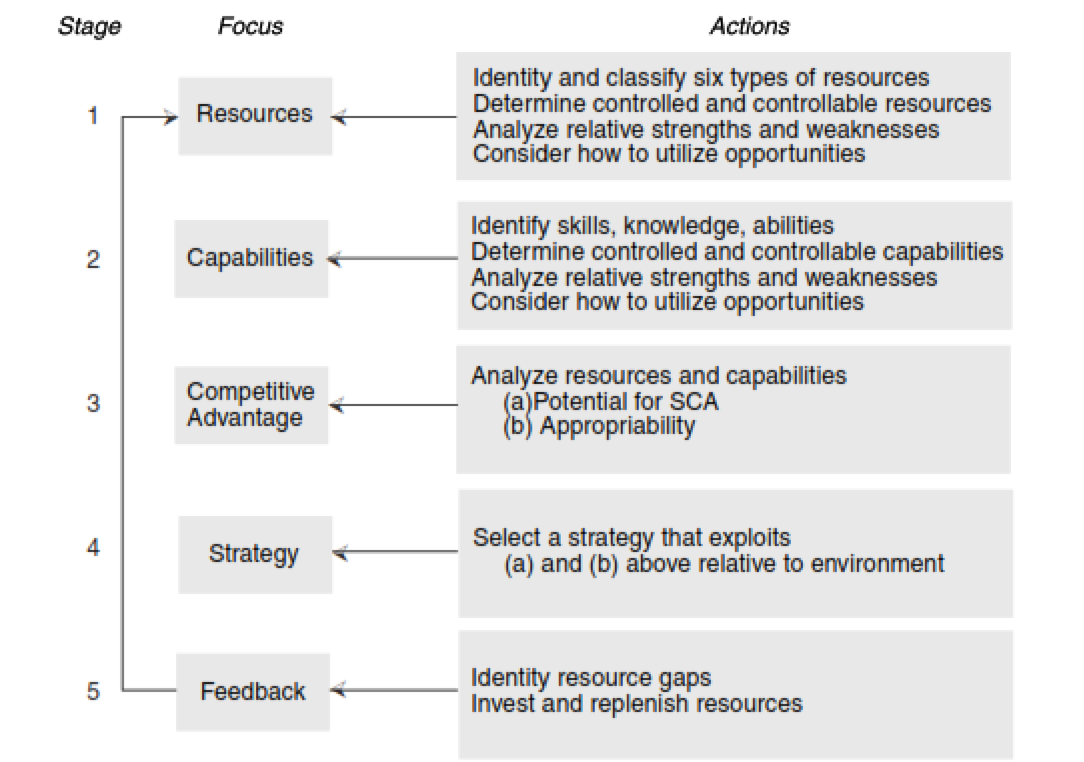
The entrepreneur also needs to ask, to what degree. To the extent that the entrepreneur can answer yes to the first question and quite a bit to the second, he or she has the basis for competitive advantage.

Stage 2: Capabilities

A firm's capabilities are the skills, knowledge, and abilities needed to manage and configure resources.[58] The second stage, then, is similar to the first, except the analysis focuses on capabilities instead of resources. Few resources, as pure inputs, can form the basis for a successful business. Usually these resources must be used in some way—a way defined by the capabilities of the entrepreneur and those of his or her team.[59] Capability makes the resources productive. The firm should have efficient capabilities to coordinate resources and foster cooperation. The hardest part of this analysis is maintaining objectivity. Entrepreneurs are tempted to overestimate their abilities and skills, or dwell on past accomplishments from which they may not be able to generalize.

- *There is no one-to-one relationship between resources and capabilities.* Each firm can create its own relationship to manage its resources. Most important, though, this relationship should result in smooth coordination and cooperation among the team members

FIGURE 4.3 **Resource-Based Approach to Entrepreneurial Opportunity Assessment and Analysis**



who perform the firm's routines. The routines themselves become intangible resources that may have the four attributes.

- *New firms have advantages over incumbents when developing routines and capabilities in industries undergoing great changes*. Older firms will have trouble changing routines to adapt to the environment; new firms can invent routines to fit the new realities. Of course, once the new venture has become established and its routines have been perfected, it is just as open to assault from an even newer challenger, which highlights the trade-off between efficiency and flexibility.
- *Some routines are widely distributed; others reside in the skills and abilities of one person*. For example, Walt Disney World is a complex amalgam of entertainment, art, technology, traffic control, and highly motivated employees. In contrast, the junk bond underwriting at Drexel, Burnham, and Lambert in the 1980s was almost solely a function of Michael Milken's abilities.

Stage 3: Competitive Advantage

Stage 3 focuses on competitive advantage. Here we try to determine whether the competitive advantages(s) identified in stages 1 and 2 may be sustained and if the profits and rents can be protected. Sustainable competitive advantage depends on the firm's ability to move first and create isolating mechanisms. First-mover advantages and isolating mechanisms prevent other firms from copying and crowding the firm's profit. The entrepreneur should ask: Do isolating mechanisms exist for the firm? Which ones should be used to protect our resource advantages?

Any rent that the firm can collect may be eroded. Physical resources may be depleted, depreciated, or replicated, or become obsolete. The probability of appropriation is high, too. The environment will seek to get a share of the rents through taxation (government), increased wage demands (employees), rising input costs (suppliers), or litigation (competitors and lawyers). The new venture's founders and leaders must be sensitive and alert to these pressures. It may serve the new venture well to create hybrid strategies that combine elements of each type of rent and use more than one kind of isolating mechanism.

Stage 4: Strategy

The next stage translates the assessment of competitive advantage into strategy. The firm requires two related strategies: one to protect and manage its resources, the other a product and market strategy. The first strategy has already been discussed in terms of isolating mechanisms and first-mover advantages. The second set of strategies entails dealing with the macroenvironment and the competitive environment described in Chapter 3.

Stage 5: Feedback

In stage 5, the entrepreneur should focus on feedback, that is, evaluating and reassessing the continuous process of new venture creation. Through the first four stages, resource gaps may have appeared and requirements for resources that are neither controlled nor controllable may become apparent. Recycling through the process after having identified the gaps is recommended. Gap-reducing and gap-eliminating strategies can be the focus of the next round. Also, resource bases are inevitably depleted and depreciated. In the next cycle, the entrepreneur must account for these erosions and make plans for investments to maintain resources and replenish stocks and assets.

As we have seen throughout this chapter, no one strategy is best for all new ventures. Because choice is crucial and many paths can lead to success, we need a way to evaluate the strategy after it is chosen but before it is implemented. If we can do this, we can weigh various alternatives against one another and make a better choice without having to incur the consequences of choosing poorly. The following four criteria may be used to evaluate proposals.[60] Each can be viewed as a test; if the strategy passes the tests, it is superior to strategies that fail the tests.

- ***Goal consistency test.*** Does the strategy help the firm to accomplish its goals? Are the strategy's outcomes predicted to be consistent with those of previous strategies and decisions? Will the strategy enable the firm to maintain its posture?
- ***Frame test.*** Is the firm working on the right issues? Does the strategy address

resource issues and alignment with the environment? Does the strategy meet the requirements of the industry stage and help acquire and control resources possessing the four attributes of sustainable competitive advantage?

- ***Competence test.*** Does the firm have the ability to carry out the strategy? Can the strategy be broken down into problems that have solutions? Are these solutions that the firm can work out?
- ***Workability test.*** Will it work? Is it legal and ethical? Will it produce the desired end? Will the organization be willing to marshal its resources to carry out the strategy?

SUMMARY

In this chapter, we reviewed a combination of theory and practice from both the strategic management and the entrepreneurship literature. Every new venture requires a consistent and workable business model. The business model tells the story of the business, explaining how the business views its products, markets, and technologies. The model also demonstrates how the business intends to make money and how this method is sustainable in the long run.

Entry wedges and momentum factors are the initial entrepreneurial strategies. The major wedges are innovation, parallel types of competition, and franchising. Various forms of sponsorship compose the momentum factors. Resource-based strategies are geared toward rent-seeking behavior. The most prevalent of the five rent-seeking behaviors is the entrepreneurial strategy. The resource-based model also accounts for the rate and direction of a venture's growth strategies. Firms grow in the direction of underutilized resources and toward areas where they have distinctive competencies.

We discussed quality as a strategy in the section on the resource-based framework. The choice of a total quality management strategy does not represent a sustainable competitive advantage for the firm. However, the implementation of such a program can provide advantages, because successful implementation requires superior market knowledge, complex service behavior from employees, and highly developed organizational systems. The best candidates for a successful TQM strategy are firms that already possess these resources.

We then looked at how industry conditions affect entry and strategy for a new venture. Five industry types were discussed: emerging industries, transitional industries, maturing industries, declining industries, and fragmented industries. Although new ventures can be successful in any of these environments, the emerging and fragmented environments provide the easiest entry and are the most typical entrepreneurial choices.

We concluded with a brief overview of the strategy development and evaluation process. Specifically, we identified four criteria for testing the appropriateness of a strategy before embarking on the market test itself. A strategy is appropriate if it is consistent with the goals of the organization, addresses the right issues, can be executed competently, and is workable both legally and ethically.