ENTREPRENEURIAL DEATH TRAPS

How to avoid the classic entrepreneurial mistakes

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Not long ago a friend of mine, a successful entrepreneur, was crying on my shoulder. "Fred, he said to me, "when I started my company I knew I needed a Mr. Inside, and I knew a good one, my friend George. I offered him 50% of the company. He'd have jumped just as quickly for 20%, but I liked the fairness feeling of being 50-50 partners.

Today, after five years of hard work, we're nicely profitable on $10 million of sales. We're pulling really good money out in salaries. We have every fringe benefit we can think of. Best of all, we've only scratched the surface. I can taste $25 million in sales in two to three years. At that level, we'll be the undisputed king of the mountain in our industry, and making so much money we won't know what to do with it."

"Gee, Lee" I said, "I'd like to be of help, but I'm having a hard time figuring out where the problem lies."

"It's George" he said. "I went into his office last week and said to him, George, we need to get away from here for a couple of days and map out a new business plan designed to triple our size by 1999."

"And what did he say" I asked.

He said, "Gee Lee, that's nice. Right now I've got to leave for my golf lesson. I'll be back by two, however, and we can talk about this. Quite frankly, though, it sounds like a helluva lot of work to me."

"Fred", Lee said to me, "George hasn't been in here on a weekend in almost a year. He's never in before 8:00 A.M. anymore and never here after 5:30. We're losing momentum and I can't carry this company by myself. He doesn't want to risk the investment that would be required to pull the thing off. And being exactly a one-half owner of the company, he can and does veto anything he wants. I'm going absolutely nuts."

I didn't have a good answer for him. As I was driving to a board meeting right afterwards though, I thought to myself, I'll bet that that's the tenth time in my career that I've heard this 50-50 partnership tale of woe. Why do such otherwise smart people keep *doing* this to themselves? After no more than an instant's reflection, I knew the answer. Because they've never been there before. Because "equal partners" seems so human-naturally fair. Boy, what a beguiling trap, even deathtrap, this has been for countless entrepreneurs, I thought.

But wait, I reflected, there's more! What about the three (or four) (or five) musketeer's death trap. Although in one sense it's a corollary of the 50-50 partnership deathtrap, in some ways it's even more insidious. You know the story. Three friends decide to start a company. They split the ownership absolutely equally, they draw identical salaries, they're going to make decisions "by consensus." It's the logical, "fair" thing to do. One of them (perhaps the oldest or the one whose idea it was originally) reluctantly assumes the presidency because state law requires there to be one.

What a recipe for failure! There are three primary problems with this set-up. First, this company has no leader, no one ultimately responsible for its success or failure. Second, sooner or later a major, honest difference of opinions will arise. What do they do then? Third, the reluctant president will almost inevitably come to see himself as "a little more than equal." If they have any success, for example, and get written up in the local or trade press, guess whose picture the reporter will want? Guess whose quotes will be plastered all through the story? Guess which other two people are going to hang the article on their family room dart board?

The solution? Pick a CEO and treat her like one. Give her the largest equity position and salary, even if only symbolically larger. Somebody has to sit where the buck stops.

By now I was on a roll. There was a cardboard box lying on the passenger seat of my car. I flipped it over to reveal its blank bottom and started scribbling notes relating to other deathtraps all over it. By the time I reached my destination, it was covered up. I counted them. There were exactly 25. Wow, I thought. I could turn this into a speech and get invitations to deliver it in places like Lawrenceville in November! And the rest, as they say, is history.

Sadly, so is the history of thousands of otherwise good little companies. Entrepreneurs face all kinds of potential adversity -- some kinds can kill them, some kinds merely set them back a little. Some kinds are unpredictable, others much more so. The saddest failures that I have witnessed are the conceivably predictable, lethal ones, the ones that could and should have been avoided.

As senseless as small business deaths are which fall prey to the many-times-tripped death traps, they can be damnably difficult to avoid. Many of them appear in the form of beautiful, well-worn paths which logic, greed and even common sense might suggest taking. How tragic that they take entrepreneurs over cliffs time and time again.

To compound the challenge of avoiding such a demise, none of these paths is assuredly fatal. The important point is that they *can* be, and have been for many others. Each should be avoided or tempered if at all possible.

We've already covered two, the 50-50 partnership deathtrap and the three musketeers' deathtrap. Although I have put the lot of them in no particular order, the third is potentially the ugliest, because when it strikes, it is only after a long run of euphoric success. For lack of a better term, I call it the One or Two Customer Overreliance deathtrap.

Let's say that you own a small, young machine shop. You're limping along, hand-to-mouth, at about $50,000 of sales/month. Then one day you get a call from a buyer at the largest industrial company in the county. He's in a jam. He needs $100,000 worth of aluminum housings in two weeks and his regular vendors are backed up for a month of Sundays. You meet with your four machinists. You know you're crazy but you take the job. You man a milling machine yourself and the five of you work 'round the clock and deliver the last of the housings at 7:00 A.M. on the deadline date. You've saved the guy's bacon. He's appreciative. Two years later you're doing $5 million in sales, $4 million of it from this one customer. You're personally pulling $300,000/year out of the company and there's enough left over to fund your working capital needs. Your bank is only too happy to finance your new equipment needs and your new, expanded building. (Back in the old days when you were a banker's pariah, you had to buy your original equipment used, out of your savings).

What do you think this guy's thinking? That this is risky? Hell, no! I'll tell you what he's thinking! He's thinking he's a genius, a role model, the envy of his friends. He's thinking that his major customer is damned lucky to have found him. In fact, he's thinking that their continued success is due in no small part to his talent and hard work

I mean, is this an accident waiting to happen or what? How many times in situations like this has such a buyer ultimately called and said something like, "Gee, Bob, 'fraid I've got a bit of bad news. As you probably knew (he didn't), our union contract has a no-layoff clause, and what with the recession and all, we've re-assigned 60 employees to our machine shop. We're bringing all of our machine shop work back in-house." Bam!

In one stroke this guy's running a million dollar company with a $3 million break-even.

Now, I am not necessarily suggesting that this poor slob should have turned any of this juicy business down. What I am suggesting is that he should have been working like mad to build the rest of his business, and thereby reduce his dependence on this customer. What I am suggesting is that in situations like this he should have been renting used equipment, not borrowing for new, etc., etc.

How could he have been so dumb?! Simple. It surely didn't feel threatening to him while it was happening, and he had never passed that way before. Picking up the pace a bit, here are the remaining 22.

4. "Mousetrap" Teams

A handful of brilliant scientists or engineers disappear into a basement and emerge six months later with an absolutely gee-whiz prototype that by all rights should run circles around the competition in the marketplace. They have, in short, invented a "better mousetrap." The world, though, to their great frustration and confusion, does not beat a path to their door.

This should not be a surprise -- no one on this team has ever commercialized technology before. Doing this well is every bit as difficult and specialized as coming up with the product itself. It is absolutely critical that this talent be found in at least one key member of the team, and preferably the CEO.

5. Inadequate Pricing

In my friend Bill Stolze's marvelous book Start-Up, he notes that "there is no start-up strategy more likely to fail than one predicated on being the lowest price competitor." Adopting such a strategy is roughly equivalent to Luxembourg insisting on settling a dispute with the U.S. with ICBM's. I would add that the statement which causes me to lose my last meal the quickest (always accompanied by big smiles, no less) is: "We're going to have the best product at the lowest price!"

The message: Price to market. Gross margin is your best friend. It can absorb all manner of adversity with two exceptions: philanthropy or pricing stupidity (actually, in this case, the two are synonymous).

6. Insufficient start-up capital

Let's give our hypothetical founders credit and assume that they prepared a cash flow projection before their launch. History shows that 90% of the time, first year sales and gross margin do not reach expectations for whatever perverse, Murphyish reason. Both affect cash needs negatively. If each founder originally chipped in the limit of his second mortgage potential, it might already be time for the fat lady to sing. Don't start a company if you cannot assuredly come up with more capital than you think you'll need. It's almost certain that you'll have to.

7. Failure to Look at the Downside

Some have called "spreadsheet spread" a plague. Even if it is, it doesn't often feature the forecasting of downside scenarios.

Consider, for example, the case of a manufacturing start-up. Three critical assumptions drive the cash flow projection - product development time, sales and gross margin. Most entrepreneurs tend to be overly optimistic with respect to all three.

If the assumptions for the three are six months development time, sales of $20,000/month growing at 25% per month and 60% gross margin, but the truth turns out to be nine months, $10,000/month growing at 25% per month and 50%, the effect on cash needed would be substantial.

Looking at the downside possibilities in advance, monitoring actual performance against budget and developing fallback plans is just about the only effective medicine for failed fundamental assumptions.

8. Failure to Look at Industry Norms

Most failed entrepreneurs claim "undercapitalization" as the culprit. More often the truth is that performance did not match the capitalization available. Overoptimism in a different form is the villain again.

With minimal effort you can learn (via trade journals, annual reports, Robert Morris Associates' Annual Statement Studies, etc.) whether your industry is closer to a 30% or a 55% gross margin business; or whether its top performers earn 4% or 18% pre-tax.

Counting on industry-unrealistic performance has drained many an initial capitalization.

9. Lack of focus

A new venture's most precious resource is talent. Doing one thing well from scratch is an enormous challenge. Tackling three or four at once is inviting across-the-board mediocrity or worse.

Carefully sort through your opportunities before you start. Focus on the marketplace and the competitive environment. Then pursue the daylights out of the best of them.

10. Bringing on the Vulture

The bad news is that while all money is green, it is not all equal. There really are vulture capitalists out there, and they don't all work for venture capital firms. They're obstructive, controlling, heavy-handed and mistrustful. The good news is, there are also investors out there who are gems -- experienced, connected, constructive, supportive - and they don't all work for venture capital firms, either.

How can you tell a jerk from a gem, before the fact? Do two things. One, ask around among the service providers - the lawyers, the accountants, the bankers. They know who the good guys and the bad guys are. Two, ask for as long a list as exists of references of CEO's of companies that firm or individual has backed, after which, call them and grill them mercilessly.

11. First Class from the Start

Show me a start-up in fancy space with lots of glass and chrome, all new furniture and equipment, and a management team drawing salaries at least equal to their old ones, and I will show you a prescription for failure. This is analogous to throwing a graduation party for yourself in the first semester of your freshman year.

Most of the best entrepreneurs I've seen have had an uncanny ability to spend a nickel in six places. They not only know that cash is, to use my favorite cash flow phrase, more important than their mother, they also realize that lack of cash is death. They part with it only if it makes a true difference, only when it stands to directly impact their objectives.

12. Inappropriate Distribution Path to Market

Sales reps are the most appropriate distribution path for start-ups, because there are no costs until and unless they sell something, right? Maybe they are, and maybe they're not, but certainly not for the reason cited. And the real danger is that word "unless", as there is nothing more expensive than no commissions owed because no sales were made. There are dozens of nuances to using reps, and for some products (big ticket, high-tech products, for example), sales reps are flat-out ineffective.

In a similar vein, I have hardly ever seen a business plan which did not highlight how trade show attendance and trade journal advertising would lead to worryingly high backlog (this is the "if they see it, they will buy" theory of sales). Short of Microsoft-sized budgets for these, I have never seen them meet expectations. The keys to the marketplace almost always lie elsewhere, and are usually nowhere near as expensive.

13. Emotional Litigation

It has been said that a lawsuit is a machine which you go into as a pig and come out of as a sausage. I am virtually allergic to litigation, and especially small business litigation. Justice is all too often *not* done. I have seen too many, multi-year, multi-hundreds of thousands of dollars, bile-producing, emotionally straining, outrageously distracting lawsuits end up with all parties agreeing to drop all actions out of acute mutual frustration.

I am not suggesting that there aren't circumstances where litigation should be pursued. What I am suggesting is that the vast majority of the time entrepreneurs would be better served by biting their tongues hard, settling out of court and getting on with building their businesses. This is not easy to do when you've been wronged! But before you decide to bring a legal action, talk to some peers who have been through the experience. The horror stories are out there in abundance.

14. Product Never "Ready" for Market

It's time to pick on the scientists and engineers again. Some just won't show their baby to the world until it's perfection itself.

This is an unattainable goal. Technology evolves. There is always an improvement that can be made, a bell or whistle that can be added. When you've developed your product to the point where it represents a clearly superior choice, freeze the design and hand it over to the sales force.

15. Low Barrier to Entry Growth Industry

Video retailing, oversized chocolate chip cookies and quick change oil franchises burst onto the scene virtually overnight. In each, there has been a tremendous shake-out of Johnny-come-slightly-latelies. CD-ROM-based multimedia products are prime candidates for being next.

If industry visibility is high and barriers to entry low, the growth rate of supply will in all probability exceed the growth rate of demand all too quickly.

16. Inadequate Market Research

A book could be written on this phenomenon alone. Suffice it to say that a failure to do adequate market research, including getting out into the marketplace and talking to at least a dozen prime customer targets before committing to a product strategy, is just asking for trouble.

17. Failure to Segment Market

The U.S. tent market is $100 million. You plan to sell high-end backpacking tents and expect to be shipping $5 million worth of them in five years. All you have to get is 5% of the tent market, right? No sweat, piece of cake.

Wrong. On closer inspection, one discovers that circus, funeral and special event tents make up 30% of the tent market; moreover, the military represents 20% and backyard family tents 20%. The two largest backpacking retailers, representing 20% of the market, own captive suppliers. That leaves 10% of the $100 million. The truth is that your falling-off-a-log $5 million sales objective represents 50% of the actual, segmented market.

18. No Reason for Customer to Change

The best entrepreneurial efforts I've seen have flowed from the development of a competitive matrix, i.e., a comparison by vendor (competitor) of all of the major factors which buyers consider when making a purchase decision. If, in reviewing such a matrix, you cannot reach the conclusion that any fully informed buyer would be crazy not to seriously consider purchasing your product, the buyer has no reason to switch to you....and probably won't.

19. Payback Can't Be Calculated

If you intend to sell your product on the basis of cost savings, make sure that these savings are clearly calculable. A claim of raw material scrap reduction can be demonstrated up front; one that promises to reduce employee back injuries probably cannot. The latter is a much tougher sale than the former.

20. Failure to Admit a Mistake

Psychologically, one of the most insidious death traps is the one which might be titled "we have too much invested in this initiative to walk away from it now" - in other words, the good-money-after-bad judgment. For all kinds of reasons (fear, ego, etc.), these judgments are tough to make objectively.

The appropriate mind-set for looking at such situations is as follows:

* To date, this has been a major disappointment.

* At some point, the level of exposure could become so large as to threaten to take down with it -- the healthy part of the business.

* Most importantly, the money invested to date is gone -- our cost basis is zero!

* The appropriate question to ask yourself is, "Would we invest the needed funds in this project today if it was presented to us as a fresh opportunity?"

21. Step Function Growth

Every once in a while I see a venture which is doing so well that sales grow by leaps and bounds for long periods of time. When such a happy event occurs, it is altogether too easy to succeed oneself into bankruptcy. So many things can get out of control -- credit checks, hiring, customer service, quality control, etc.

If business ever gets so good that you feel out of control, you probably are. Step back, take an objective look at things and adjust accordingly.

22. Betting the Ranch

Contrary to legend, great entrepreneurs are not high risk takers. They are not afraid to take a moderated risk which is largely within their control, but they would never bet the ranch, whether on an acquisition, new product or anything else. They will not risk all that they have, even for what appears to be a "sure thing." It is amazing and frightening how a "great opportunity" can quickly grow to need three times the cash flow generated by an old, "cash cow" line of products.

23. Ignoring the Handwriting on the Wall

Holding on to old ways, continuing to rely on original, bedrock assumptions in the face of mounting evidence to the contrary, can take a healthy company down in an amazingly short period of time.

Some years ago the stuffed toy industry began to quickly shift to offshore production in order to reap the benefits of low wage rates. A previously successful domestic manufacturer reacted to its eroding market share by cheapening its line, thereby reducing product quality and image, while addressing the wage cost differential only marginally. Needless to say, this did not produce the desired results. Ultimately the firm admitted the inevitable and redirected its efforts into other areas, abandoning stuffed toys for good.

24. Spiraling costs

As you expand from garage-quality space to an industrial park, as you finally hire that chief financial officer, as you install the new computer system, as you bring on additional production equipment, your break-even level will creep, maybe even gallop, inexorably higher and higher. While none of the above is frivolous, any or all of them could subject you to the risk of losses in the event of a downturn.

Particularly if you are in a cyclical and/or recession-sensitive industry, build your various infrastructures very calculatingly. Develop fallback plans well before you need to implement them.

25. Silliness phase

Now we come to the frivolous! While few small companies ever get to the far (company jet) edge of the silliness phase, lesser gluttonies can produce the same effect. "I really need my own secretary now that we're on top of the heap." "If ABC Corporation can afford leased Mercedes and country club memberships for their execs, we surely can." "This place needs some decent art on the walls -- in fact, it needs some serious interior decoration attention."

Beyond the obvious non-productive costs of this disease, its most insidious characteristic is its primary side effect -- it inflicts major damage to workforce morale and management energy, sharpness and desire.

As you go about building your business, keep this list in mind. It may sound strange, but you can't succeed if you don't avoid failure. Entrepreneurial human nature is to just play offense; but even in business building, defense is critically important. Avoid making these classic mistakes and you can be assured that you have substantially increased your chances of winning the game.