The economics of entrepreneurship 1: Entrepreneurs & startup types (I)

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Learning objectives of the topic

- To become familiar with popular ideas of an entrepreneur and his/her role in the economy
- To understand the concepts of the one-shot, serial and portfolio entrepreneur
Learning resources for the course

- **Textbooks**
    - Report of a major study of startup businesses, reading for The typical entrepreneur
  - David Storey, *Understanding the small business sector*, Routledge, 1994
    - Useful background reading to The typical entrepreneur
    - A useful text for venture capital-financed fast growth businesses

Resources cont’d

- **Course website**
  - [http://www.staff.city.ac.uk/~cressy](http://www.staff.city.ac.uk/~cressy)
  - This will contain copies of
    - Course
      - Outline and
      - References
    - The class exercises
      - at least one day before the lecture
    - The lecture notes (containing answers to exercises)
      - one day in arrears
    - Past exam papers
Resources cont’d

- **Data sources** (accessible via the CK library at CUBS)
  - [www.datastream.com](http://www.datastream.com)

- **Other specific sites of interest** will be mentioned as we go along. These include
  - [www.Amazon.com](http://www.Amazon.com)
  - [www.ebay.com](http://www.ebay.com)

Learning assessment for the course: Coursework

- Coursework will consist of the preparation of a business plan for a startup

- **Structure of the presentation**
  - Done in teams of up to 5 people
  - 15 minute presentation by each team
  - Follower by 5 minutes of questions by the panel to all team members

- Writeup of the plan
  - To be delivered 1 week after presentation

- Assessment scheme
  - Presentation and write-up both count in mark (50%; 50%)
  - Equal marks awarded to each member of a team
Arrangements for presentation

- Date: Held in the last two sessions of the lecture series (weeks 9 and 10?)
- Place: in the normal lecture room
- Technology:
  - Powerpoint software will be used
  - Slides loaded on to my laptop (don’t bring your own)
- Timetable: I provide you with a time slot
- Slides: You email me the slides 1 day in advance of the presentation
- Audience: Only the presenting group will be allowed in the room at any one time
- Preparation: lecture on writing a business plan (week 8?)

Learning assessment:
Examination

- The exam will last 2 hours and consist of 6 questions of which you have to do 3.
- Past exam questions are on the course website
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Reading for the topic

- Reading for topics 1, 2 and 3
  Cressy and Storey, New firms and their bank
  Storey, Understanding the small business sector:
    Chap. 2, “Small firms”
    Chap. 3, “The birth of firms”
    Chap. 4, “The death of small firms”
    Chap. 6, “Employment”
Exercise 1: Perceptions of the entrepreneur

- What do you think are the common perceptions of an entrepreneur?
- What sort of person is (s)he and what does (s)he characteristically do?
- List at least 5 different characteristics and/or actions you think symbolise these perceptions

1/ Popular conceptions of the entrepreneur
(Answer to Exercise 1)

- The entrepreneur is popularly thought of as possessing some or all of the following characteristics:
  - Risk-taker (hence a risk-tolerant/risk-loving person)
  - Innovator/New Frontiersman/Visionary business person
  - Deal-maker/Trader/arbitrageur
  - Organiser of resources (e.g. land, labour, capital)
  - Opportunist money-maker
  - Someone who starts and runs their own business
Risk-taker (hence a risk-tolerant/risk-loving person)

- Environment: uncertainty about costs and returns to investment
- Motivation/skills: Someone who has greater risk-tolerance than the norm
  - May even enjoy taking business risks
  - Often swash-buckler mentality
  - Profits are seen as the extra reward to risk-taking
- Personality: Willing to gamble on her own judgement about returns to investing
- Individuals:
  - Richard Branson (Hot air ballooning, transatlantic power boat racing, plus many business risks)
  - X Smith (FedEx, global express mail delivery service)

Conceptions cont’d

- Innovator/New Frontiersman/Visionary business person
- Environment: Imperfect knowledge, uncertainty, technological and market change
- Motivation/skills: Someone who will revolutionise or significantly change the world of business
- Personality: Ambitious, self-motivated, energetic, visionary, strategic, persuasive, courageous
- Individuals:
  - Henry Ford (Ford company, automobiles)
  - Bill Gates (Microsoft, computing)
  - Anita Roddick (Body Shop, cosmetics)
  - Geoff Bezos (Amazon.com, bookselling)
  - X Smith (FedEx, global express mail delivery)
Conceptions cont’d

- Deal-maker / Trader / arbitrageur
  - Environment:
    - Trading / market environment
    - Individual deal-makers
  - Motivation / skills:
    - An expert in negotiation, deal-making and contracting
    - Shrewd in bargaining psychology and strategy
    - Capable of getting advantageous terms agreed on deals
    - Typically willing to trade something in order to get something
    - Someone with superior business acumen who can see opportunities for riskless profit opportunities (arbitrage)

- Personality:
  - Swash-buckler
  - Abrasive?
  - Pushy

- Individuals
  - Stockbrokers and market-makers in stocks
  - Floor traders on the stock exchanges
  - Gavin Kennedy (“The pocket negotiator“)-types
Conceptions cont’d

- Organiser of resources (e.g. land, labour, capital)
- Environment
  - Competitive market conditions
    - He runs a business under conditions of perfect information and certainty
    - He takes price and technology as given
    - does a calculation based on known technology, consumer tastes and prices
    - brings together resources to produce the output that maximise profits
- Motivation/skills
  - He sets up a firm to do this because it yields a greater return than working for someone else
  - This presupposes superior ability in managing than being managed
  - In the modern version of this theory under quantifiable uncertainty individuals become entrepreneurs because they have greater risk tolerance than others

Conceptions cont’d

- Personality
  - Profit maximising
  - Passive: Price taker
  - Individualistic (acts independently rather than in co-operation with other market participants)

- Individuals
Conceptions cont’d

- Opportunist money-maker
  - Environment
    - Large business
    - Intrapreneur
    - Small business
    - Self-made portfolio entrepreneur
  - Motivation/skills
    - The magpie conception of the entrepreneur
    - Always on the look-out for opportunities
    - Gambler on ideas
    - Restless quest for profit
    - No grand vision, rather someone depending on a series of chance-driven money-making events
  - Individuals
    - Victor Kyam: “Going for it”
    - Richard Branson: Virgin

Conceptions cont’d

- Someone who starts and runs their own business
  - Environment
    - Local market
    - Services rather than manufacturing
    - Non-innovative
    - Slow/no growth
  - Motivation/skills
    - Ordinary person
    - Male rather than female
  - Personality
    - Desire to be their own boss
    - Often a job changer
    - Fiercely independent
Individuals

- These are almost by definition not known outside a local circle or network unless they have achieved fame through other means
- Some examples of this sort of individual are:
  - Brian Prime (sometime Chairman, Federation of Small Businesses)
- Both these individuals originally ran their own successful local businesses

2/ What do we mean by ‘entrepreneur’?

- We define an entrepreneur, for the purpose of this topic, simply as someone who starts their own business
- A person who does this is what we call the typical entrepreneur
- Later in the course we look at a particularly important minority of businesses, namely (potentially) fast growth businesses
  - The typical person starting this kind of business we shall call the sophisticated entrepreneur
Meaning cont’d

- Our definition of the typical entrepreneur does not preclude her role as
  - Risk-taker
  - Innovator/ New Frontiersman/ Visionary business person
  - Deal-maker/ Trader/ arbitrageur
  - Organiser of resources (e.g. land, labour, capital)
  - Opportunist money-maker
- However, as we shall see, the majority of startup entrepreneurs are much more low-key than these descriptions suggest

Exercise 2:

Taxonomical investigations

- Talk to your right-hand neighbour.
  - How would you classify business startups?
  - Think of at least 2 different types of startup using this taxonomy
3/ Entrepreneurial Types

- The definition of an entrepreneur as someone who starts their own business includes:
  - Members of team starts
    - Groups of entrepreneurs who jointly start a business
  - Business purchasers
    - People who buy an existing business from someone else
  - Franchisees
    - People who license a business concept from others
      - E.g. Body Shop, Pizza Express, ProNuptia

Types cont’d

- Serial entrepreneurs
  - People who have been in business before
- Portfolio entrepreneurs
  - People who run more than one business at any one time
    - Fact: the majority of fast growth businesses in the world are run by portfolio entrepreneurs
Exercise 3
Portfolio entrepreneurs

- What do you think could be
  - the advantages
  - the disadvantages
  of running several businesses at once?
- If you were an entrepreneur do you think that you would be likely to run more than one business at the same time?

Portfolio pros and cons
(Answer to Exercise 3)

- Advantages of portfolio approach
  - Risk reduction
    - Income risk reduction
      - A wider range of products and/or services means that fluctuations of the entrepreneur’s average income from a business are lower
      - See Box 1 for a statistical illustration
Box 1: Income risk and the business portfolio diversification

- Suppose you have £10,000 that you can allocate to one or two businesses with uncorrelated returns.
- For each businesses suppose that returns are either 20% or -10% per £ invested with probability ½ respectively.
- Finally let each business have the same expected return 5% per invested and the same variance of return (risk) of 1% around the mean.

Diversification cont’d

- Solo business strategy
  - The expected wealth from investing in a solo business is £(10k)(.05)=£500, with risk £[(10k)^2](.01)=£100m(.01)=£1m.
Diversification cont’d

- **Portfolio strategy**
  - If instead of investing it all in one business the entrepreneur invests half each in two businesses with the same individual variance 1% then, if these returns are (for simplicity only) independent then
    - Her expected return is the same as for the one-shot at £.500
    - The variance of her wealth is now halved to 
      \[ \frac{(10k)^2(0.05)}{2} = \frac{1m}{2} = 500k. \]
  - Thus, portfolio entrepreneurship is less risky, other things equal, than one-shot.
    - In the language of finance the firm-specific risk is reduced

Diversification cont’d

- **Large portfolio**
  - If we take this logic to the nth degree, we find that in the case of independent business incomes, risk can be eliminated with a large enough portfolio
  - More plausibly, if there is some positive fractional correlation between the incomes of the business, portfolio diversification will still reduce risk to a limited degree depending on the strength of the correlation
    - In the language of finance, the remaining risk is systematic
Pros and cons cont’d

- Bankruptcy/insolvency risk reduction
  - A less fluctuating income reduces the chances of the entrepreneur’s income (the sum of the incomes from all the businesses) falling below the level necessary to service debt payments
  - Cross-subsidisation of businesses in the portfolio becomes possible:
    - Assume that the portfolio business incomes do not move precisely in the same direction at the same time
    - Then when one is low at least one of the others is likely to be high
    - This makes cross-subsidisation (moving money between businesses) possible and insolvency less likely and growth more likely

Pros and cons cont’d

- Income enhancement
  - Expected income is in general larger if more businesses are operated
  - The portfolio can be selected to ensure
    - returns to new businesses are at least as great as existing ones
    - This increases the average return
    - More is invested in better-performing businesses
    - Ditto

- Taxation
  - Government small business allowances can be used to the full
  - Each new business added to the portfolio gets the same allowance
  - Hence if the entrepreneur has a new product or service it is sensible to start a new business rather than develop it within the existing business
Pros and cons cont’d

- Disadvantages of the portfolio approach
  - Management problems
    - Running several businesses at once requires greater managerial skills
    - Co-ordination of business activities in the portfolio

Pros and cons cont’d

- Human resources management
  - If the entrepreneur manages all of the businesses single-handedly she will be limited by time factors
  - If managers are employed to run the individual businesses these need supervision/monitoring

- Financial management
  - Book-keeping is more complex
  - May require delegation to an outside accountant
6/ Summary and conclusions