The Entrepreneur's Guide to Financial Maturity ®
Risk Management for the Small Business

As a business consultant and teacher at NYU School of Continuing and Professional Studies, I have the pleasure of meeting many entrepreneurs and potential entrepreneurs and reviewing, or assisting in preparing, their business plans. I have often heard small business owners telling me and/or potential investors that investing in their business opportunity is as safe as investing in government bonds.

I have seen an entrepreneur try to offer potential investors 6% per annum on risky investments such as second mortgages on construction projects. Further, that entrepreneur might have virtually none of her own money at risk, is inexperienced as a builder or developer, and it is highly probable that there will be significant delays in starting and completing the project. Additionally, as with most construction projects, in all likelihood there will be cost overruns. It is clear that if delays or cost overruns occur, an investor will either be compelled to invest more money (in a failing project to protect his or her investment), or (potentially) loose some or all of his or her investment. In my opinion, either option is unacceptable considering the meager 6% annual reward. Similarly, I have seen undercapitalized small businesses and startups offer low returns to potential investors.

When I delve into entrepreneurs' motivations for offering meager returns, the response generally has been, it is better than earning 1% or 2% in your money market account and it is just as safe. Those entrepreneurs are ignoring the possibility that investors could lose 100% of their investment.

Those entrepreneurs either failed to recognize certain business risks, failed to recognize the implications of assumptions they made or chose to ignore the risks. **One reason why 4 out of 5 businesses fail within 5 years of their inception is that entrepreneurs do not understand business risks before they start or buy their business.** Entrepreneurs and their friends, families

and investors loose billions of dollars each year when their small businesses fail.

My experience tells me that part of the reasons a business owner feels his or her business opportunity is low risk, is because the business owner:

- Is too close to the situation and therefore lacks objectivity
- Oversimplifies what has to be done to achieve certain their goals and objectives
- Underestimates the importance of the assumptions they made
- Does not understand the true risks of their business
- Has not explained thoroughly how risks have been mitigated

Most business plans I review do not adequately address business risks, and many plans do not address business risk at all. In addition, those business owners who have their business plan in their heads or on the back of napkins, tend to oversimplify their business and do not appropriately address business risk.

The business risks I will be addressing in this article are not whether you should incorporate, or what type of insurance to carry. The business risks outlined below are not all inclusive. It should be used to help stimulate your thought process so you can better understand your existing or potential business. If you are prepared to invest money (either your money or friends and family money) into a new or existing business, you will make a more informed and better decision after you and your team has fully evaluated the business risks. After evaluating the business risks, often the entrepreneur recognizes that the initial thought process was flawed, and backs away from making what would have become a bad investment.

To summarize how various types of investors evaluate your company, they generally look at the risks associated with the following major categories:

- Startup
- New Product Development
- Manufacturing
- Distribution
- Marketing/ Market Acceptance

- Management
- Growth
- Financial
- Exit Plan

For example let's look at some basic risks that virtually every company faces or will face at some time in its business life cycle.

Startup Risk:

Startups and companies that have a limited or no operating history generally carry considerably greater risks than profitable companies. When I deal with startups, often the business owner's information about the business is limited. The start up company has no revenues, and often has to pay for equipment, furniture and fixtures, inventory, supplies, security deposits and carrying costs until the business generates sufficient "cash flow" to support itself. Often events do not occur as anticipated and it takes more money to accomplish those elusive goals and objectives. If the company is undercapitalized, and it takes longer to generate sales than anticipated, it could be out of business.

Management Risks - Reliance on a limited number of key people:

Often many small businesses have not developed a company infrastructure or succession plan. If hypothetically, you or a key member of your staff got "hit by a bus" how would that impact your business? If that, or similar events would cripple your business, your business is high risk.

Reliance on a limited number of key people is one small component of management risk. There are a wide variety of risks associated with management risks.

New Product Development Risks - Delays in getting your Product or Service to Market:

Delays in getting your "deliverables" to market can be devastating. This is true regardless of whether you are involved with:

- New product development

- Sales of goods or services or
- Real Estate

If your company has monthly overhead (monthly operating expenses), than excessive delays will burn through cash. If it takes several months longer to get your service or product to market, your company needs the cash, or credit facility to support operations during these delays. Lack of knowledge and poor planning frequently causes excessive delays. If an investor does not feel comfortable with your product, industry, customer knowledge, you will be perceived to be a higher risk than someone who has that knowledge. If you burn through your cash before you are market ready, you are destined for failure.

Delays in getting your product or service to market are one small component of new product development risks. There is a wide array of risks associated with this category.

<u>Marketing Risks - Not fully Understanding your Selling Cycle:</u>

When I ask small business people to describe what it takes to sell their product or service, many are perplexed. I generally ask a series of questions including those listed below so that we can better understand what it takes to make the sale.

- Who are your customers?
- What are their shopping habits?
- Where do they shop for products similar to yours?
- How frequently do they shop for such products?
- How many different stores or service providers do they go to before making a decision?
- How many days are spent shopping before the purchase decision is made?
- How many competitive products do they consider?

The above is a very short list of understanding how you are going to generate revenue, the cornerstone of any business.

Marketing Risks - Your Competition's reaction:

Those entrepreneurs that fail to recognize that the marketplace is dynamic and constantly changing are destined to become the dinosaurs of their industry. If you become a lower cost provider of a service, others may react in order to maintain their existing customer base. Enhancing productivity through innovation is the norm. As you improve your processes, so will your competitors. As you change your pricing, don't be surprised if your competitors match what you are doing. If you are anticipating a 20% increase in your sales volume by enhancing your service or reducing your price, do not assume your competitors will not react. In all likelihood your competitors will do what is necessary to keep the business their existing business.

Not fully understanding your sales cycle and your competition's reactions are two small components of marketing risks

Manufacturing Risk:

Many businesses that sell products using their own brands do not manufacture or assemble their own products, and therefore feel they have no manufacturing risks. Many entrepreneurs take the position that they are purely marketing companies, and the product, which is sold under their company's label, is incidental. "We are outsourcing our product to Company X and they manufacture for some of the top companies in our industry." Accordingly, "we have no manufacturing risks." Those statements show their naivety.

When I ask a business owner how did they select the subcontractor, and why did they select one that is overseas, they quickly point to a cost savings of having the manufacturing. When I question them ask as a small business wouldn't you be better off producing the products locally, since you can monitor production and quality better, they agree.

Business owners often fail to recognize that goods are manufactured to specifications. If you are using the same manufacture as your competition and your specifications are different than your competition, the products are not necessarily comparable. If your product has seasonality, and a large competitor needs more of their product, your production will be done once the manufacturer has free time. That may cause you to miss deadlines or selling seasons.

If your product were produced locally, you or one of your employees would visit the manufacturer frequently. You would determine if the products used were as specified.
You would be able to make sure it met your standards for quality.

If your products are being manufactured abroad and you are not monitoring those contractors in the manner you would monitor a subcontractor located in next door, you have quality control and delivery risks. By manufacturing locally you reduce your learning curve. Once you have gone through the learning curve you are in a better position to negotiate terms with a manufacturer. When you achieve certain sales volumes you can have someone monitoring your manufacturer in a cost effective manner. If you fail to monitor for overseas manufacturer and there is a problem, you might not find out about production problems, quality control problems etc., until it is too late.

In Conclusion:

Understanding your risks and how others perceive your risks can have a dramatic impact on your company's vision and business operations. It will become a factor in how you allocate your resources and time. Your outside Board of Advisors should help you focus on risks and how you are allocating your resources.

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