

Patterns in Entrepreneurship

There are many ways for aspiring entrepreneurs to get in the arena

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MBA students frequently express interest in “doing something entrepreneurial” after completing their graduate degree program. To satisfy this demand and to assist students, over the last decade, business schools have added faculty, courses, and programming in the field of entrepreneurship.³ Despite these extra resources, in our experience, most MBA students with an interest in entrepreneurship consider only a narrow range of potential business opportunities. We aim, in this note, to highlight the multiple ways to become an entrepreneur.

In our view, entrepreneurship is a big tent. Although Silicon Valley technology ventures and flashy consumer products startups receive most of the attention in the media and on campus, there are other ways to jump into the entrepreneurial arena. This note explores six patterns in entrepreneurship (and there might be many more), some of which fly under the radar of many MBA students. This note will not advocate any single entrepreneurial path over the others.

We approach this endeavor with an open mind, and hope that readers will as well. There is no right or wrong pattern in entrepreneurship. Rather, we believe that aspiring entrepreneurs owe it to themselves to learn about and contemplate a variety of options. Then, with better information and a higher degree of confidence, they can rigorously evaluate which entrepreneurial path best suits their specific interests, needs, and goals. Additionally, we encourage aspiring entrepreneurs to factor risk and lifestyle into their decision-making process. Which form of entrepreneurship has the highest probability of success, however you define it? And which one will best accommodate the lifestyle you envision for yourself?

We offer below a wide-ranging but non-exhaustive analysis of six distinct paths to entrepreneurship:

- 1) venture capital-backed technology startups
- 2) cool branded consumer products companies
- 3) “boring and basic” models
- 4) franchisee operators
- 5) search funds (i.e., entrepreneurship through acquisition)
- 6) genealogical takeover of a family business

In our profiles, we provide real-life examples to make this note as practical and actionable as possible. In addition, we employ two academic frameworks to help structure our analysis. First, we use Harvard Business School Professor Howard Stevenson's definition of entrepreneurship as "the pursuit of opportunity beyond resources controlled."⁴ This formulation, in our view, is sufficiently broad to encompass the wide range of creative and constructive activity that businesspeople engage in to build something that does not yet exist. Second, we apply the "rich or royal" model developed by Noam Wasserman, who currently serves as the dean of the Sy Syms School of Business at Yeshiva University.⁵ As we see it, aspiring entrepreneurs are likely to face the tradeoff between wealth and control at some point in their journey, so this is an important concept to understand.

Venture capital-backed technology startups

The story of an entrepreneur who makes it big in Silicon Valley by building the next great technology company has claimed a special place in popular consciousness. Each decade since the 1970s seems to have added another chapter to this mythology. The big success stories include Microsoft and Apple in the 1980s, Yahoo and Amazon.com in the 1990s, and Google and Facebook in the 2000s. The second great internet boom, which began in the wake of the Global Financial Crisis, gave rise in the 2010s to a new generation of large fortunes and iconic business leaders – and the goal among entrepreneurs of creating the next unicorn. Most MBA students could name at least one startup that has experienced a meteoric rise over the last decade, and a fair number yearn to get into this entrepreneurial arena themselves after graduation.

For illustrative purposes, consider one of the prime examples of a VC-backed technology startup that made it big over the last decade: Slack Technologies (Slack). Much about Slack's story seems to have been tailor-made for a Hollywood movie version of striking gold in Silicon Valley during the 2010s.⁶ Slack's founder and CEO, Stewart Butterfield, rose to prominence from humble origins. Born Dharma, not Stewart, in 1973 to hippie parents on a commune in Lund, British Columbia, Butterfield spent the first four years of his life in a small home that had no running water, electricity, or telephone. His family moved to Victoria in 1977, where Butterfield grew up, legally changed his name from Dharma at age 12, and earned an undergraduate degree in philosophy. He then went to England and completed a master's degree at Cambridge in the mid-1990s.

The heady growth of the internet during this period convinced Butterfield to abandon academia and return to British Columbia in search of business opportunities. He worked for a few startups that didn't go anywhere until he co-founded an online gaming company in 2002. That venture, Ludicorp, struggled to find its footing, but the image-sharing technology it developed showed considerable promise. In 2004, Butterfield and his associates pivoted to focus on further developing this software – and created Flickr, which quickly became the online photo-sharing platform of choice. Butterfield sold the company to Yahoo in 2005 for roughly \$25 million, relocated to the San Francisco Bay Area to manage the transition for another three years.

In 2008, after a tumultuous six months both professionally and personally, he moved back to Vancouver. He soon launched another online gaming venture. Despite considerable efforts, this second attempt in gaming also did not pan out. Remarkably, however, an even more interesting piece of technology came out of this failure: a group chat application that the team had developed to work together. The software morphed into Slack, which launched to the public in 2014.

By 2019, leveraging a freemium business model built largely upon word-of-mouth marketing and a Trojan horse strategy with group chat, San Francisco-based Slack had achieved remarkable market

penetration, with over 12 million daily active users⁷ at more than 600,000 organizations in 150 countries.⁸ Slack went public in June 2019 and reached a market capitalization of nearly \$20 billion on its first day of trading. By the end of the year, however, fears of competition from Microsoft and a general shift in sentiment away from high-flying unicorns had caused Slack's valuation to fall to roughly \$12 billion.⁹

Barriers to entry

Launching a technology startup involves overcoming a variety of barriers to entry. Arguably the greatest challenge is developing a revolutionary idea that can be commercialized. Unfortunately, there are very few of these truly exceptional insights. The likelihood of coming up with a winning concept is slim, even for highly educated people, and the odds of doing so probably will not change materially anytime soon. However, the situation is not static. Some obstacles along this path to entrepreneurship have become easier to clear, while other hurdles remain high or have gotten higher.

The proliferation of cloud computing technology has significantly lowered the cost of developing and distributing software. By 2020, a software startup could obtain nearly limitless amounts of computing power, storage capacity, and network bandwidth from hyper scale cloud vendors such as Amazon Web Services and Microsoft Azure. This means that even if the company becomes quite large, global even, its capital intensity remains low. In the past, a new venture would have to buy its own hardware devices, including servers, storage appliances, switches, and routers. This would require a fair amount of capital just to get going, and over time, the budget for capital expenditures likely would expand in line with revenue growth.

The cloud revolution has sweeping implications – a small startup can rapidly build, test, update, and push its highly sophisticated software to users around the world. And by leveraging agile development techniques, new technology ventures can bring their solutions to market more quickly than ever before. Speed is the name of the game, and small is often much more nimble than big.

Further lowering the barriers to entry is the robustness of the venture capital market. The flows into the venture capital asset class have been staggering over the last decade, leading to tremendous competition among investors to provide funding to promising startups. Seed-stage financing arguably has never been more easily available, even for embryonic ventures that are little more than a founding team with some code and a slick PowerPoint pitch deck. According to CrunchBase data, the amount of venture capital invested in deals under \$5 million, as measured by the size of the financing round, reached \$7.7 billion in 2018, up from \$2.9 billion in 2008.¹⁰

That said, it still can be very difficult to raise venture capital. The average partner at a seed-stage Silicon Valley venture capital firm will evaluate, to varying degrees of depth, about 1,000 startups per year, but perhaps invest in just three or four.¹¹ That small handful of new ventures, through a combination of skill, perseverance, and luck, will have successfully navigated a fundraising process that takes an average of six months and involves six discrete steps before any cash changes hands. Any one of these steps could doom the startup's chances at securing capital from the venture capital firm. The six typical procedural hurdles are: 1) initial introduction to the venture capital firm, ideally a warm one, 2) submission, usually by email, of the startup's pitch deck, 3) an initial phone conversation between the startup and the venture capital firm, 4) the first in-person meeting, 5) a second in-person meeting, and 6) deal structuring and approval of fundraising documents.¹²

Navigating among the many potential VC investors can also be daunting. Each firm makes decisions in its own way, informed by an idiosyncratic mix of quantitative, qualitative, objective, and subjective factors.

To the extent that generalization is possible, Silicon Valley venture capitalists actually look at similar criteria, despite weighting them differently. There are certain readily understandable table stakes, including a compelling business idea or plan, a rigorous market analysis, financial projections, estimates of future fundraising requirements, and a pathway to profitability and exit over seven to ten years. Perhaps the most challenging part of the evaluation, but often the most important in the seed stage, is the assessment of the founder or founding team. Venture capitalists want to gauge entrepreneurs' organization, integrity, character, passion, resilience, self-awareness, coachability, and drive. They also seek to determine whether there will be "a good match" between the venture capital firm and the startup over the course of a professional relationship that, through various ups and downs, could last nearly a decade.¹³

Two other factors in recent years have increased the barriers to entry in the world of high-tech startups. First, a handful of software, internet, device, and e-commerce companies have built ecosystems around core businesses with demand-side increasing returns to scale (which are commonly, but not always accurately, referred to as network effects). This means that as the big get bigger, it becomes ever harder for small new entrants to even compete with the giant incumbents, let alone displace them. Second, easily available venture capital has fueled a fierce war for talent, especially for software engineers. Top-notch coders command large compensation packages, and many of them jump from one firm to the next in search of ever-higher levels of remuneration.

Key differentiator

VC-backed technology startups differentiate themselves in a variety of ways. Some startups focus on developing a sleek user interface that is not only visually appealing but also makes engaging with the software more intuitive. After all, if the software looks great and easy to navigate, the customer is likely to use it more often and, in some cases, to pay more for the right to use it. Integration with other software is another important point of differentiation. The more applications that a startup's offering can interact with, the more useful it becomes. This dynamic explains why so many technology startups try to create platforms on which other developers can build applications. Providing a lower-cost business solution is another tactic that software startups often employ. That said, price tends to be a less-powerful differentiator in consumer-oriented software businesses, because the product or service is often monetized indirectly. For example, advertisers, not users, generate Google's search revenues. To be sure, software features also matter in setting technology startups apart from the pack. However, this form of differentiation tends to be short-lived in software, a field in which copycatting and reverse-engineering are hallmarks.

In its early days, Slack differentiated itself through product functionality and ease of use. Over time, integration with other software applications became a major selling point. More recently, however, the durability of these competitive advantages has come into question. The reason was simple: Microsoft launched a very similar software offering in 2017, and just two years later, it apparently has attracted more users than Slack has.¹⁴

Path to going concern (product-market fit)

Raising outside capital in distinct rounds, instead of all at once, shapes the path that VC-backed technology startups take to become going concerns. Entrepreneurs usually must achieve certain milestones before new or existing investors are willing to provide additional funding. Attracting outside capital is crucial because very few, if any, technology startups will generate sufficient funds internally to scale their operations. Nevertheless, we want to emphasize that securing external financing requires these ventures to demonstrate *operational* progress. Typically, technology startups will have to course-

correct, or pivot, a number of times, before stumbling upon a workable business model – if they manage to do so at all.

In a tech startup's early days, the entrepreneur typically will self-fund a venture. Perhaps she will be able to raise a modest amount of funding from friends or families. If the concept behind the startup seems promising, angel investors typically will be the next source of capital. Angel investors – often retired entrepreneurs who made it big themselves in the technology industry – provide seed funding, usually in the range of tens of thousands to a few hundred thousand dollars. They make their investments so early in the startup lifecycle that their thesis usually relies on assessments of the “big picture” opportunity and the quality of the founding team that is chasing it. With this external capital in hand, the entrepreneur must quickly but efficiently spend it in ways that produce tangible evidence of the startup's progress and/or momentum. At this stage, completion of a minimum viable product, imperfect though it will be, allows startups to approach target customers with something to try. This experimentation, often in the form of a pilot project, may or may not generate revenue, but that tends to be less important than metrics that measure customer adoption or usage.

On the strength of this initial feedback from the marketplace, the entrepreneur will next try to raise institutional venture capital for the first time through a Series A financing round. Some institutional venture capital firms focus exclusively on this part of the startup funnel. Others invest at this early juncture, as well as later stages. And there are still more who only back startups once they have gained significant traction. Ultimately, entrepreneurs need to understand what their target investors care about. During a Series A round, venture capitalists typically want to see market sizing analysis, the number of users, both free and paid, customer acquisition costs, customer lifetime value analysis, the growth in the user base, and engagement metrics. Arguably, above all else, venture capitalists want to see evidence that growth is not only occurring but also sustainable, if not accelerating.

This process repeats in subsequent rounds of financing, although the metrics and milestones that demonstrate traction will likely change. In one round, investors may prioritize growth, only to shift their focus to rate of cash burn in the next one.

We caution students against concluding that profits and cash burn do not matter in this form of entrepreneurship. The question is when profits and cash burn start to matter. Generally speaking, revenue growth is the primary goal for a VC-backed technology startup for quite some time, years even. That said, although venture capitalists typically demand high levels of revenue growth, they still expect that each of these firms can demonstrate a pathway to profitability over time. Peter Thiel, the prominent entrepreneur-turned-venture-capitalist, explained the thought process of Silicon Valley investors in *Zero to One*, his popular book on entrepreneurship, in the following way:

Simply stated the value of a business today is the sum of all the money it will make in the future. (To properly value a business, you also have to discount those future cash flows to their present worth, since a given amount of money today is worth more than the same amount in the future.) Comparing discounted cash flows shows the difference between low-growth businesses and high-growth startups at its starkest. Most of the value of low-growth businesses is in the near term. An Old Economy business (like a newspaper) might hold its value if it can maintain its current cash flows for five or six years. However, any firm with close substitutes will see its profits competed away. . . Technology companies follow the opposite trajectory. They often *lose* money for the first few years: it takes time to build valuable things, and that means delayed revenue. Most of a tech company's value will come at least 10 to 15 years in the future.¹⁵

Of course, belief is very different from reality, and the larger a startup's near-term losses get, the bigger the eventual perceived payoff must be. For investors to have confidence in underwriting such long-dated cash flows, entrepreneurs must not only paint a picture of how big the ultimate payoff might be, usually in the form of a steady-state financial model, but also provide tangible evidence that the startup is laying the foundation to support high levels of profit generation well into the future. As a result, customer adoption rates, customer acquisition costs, cohort analyses, retention figures, recurring revenue dynamics, engineering headcount, growth in the sales organization, and marketing spending are among the most important variables that technology entrepreneurs must optimize for while attempting to scale their businesses. The general model in the software business illustrates why. In that industry, a customer base above a certain minimum size will allow a company to achieve significant leverage on its R&D investments, sales and marketing expenses, and administrative overhead. Realizing these benefits of scale will drive substantial margin expansion on a highly visible recurring revenue stream that does not require much ongoing capital investment to perpetuate. But that's the perfect scenario – when everything goes to plan. Unfortunately, in the vast majority of cases, achieving this “flywheel” will never happen, since investors will not tolerate funding losses into perpetuity, even if they accept doing so for a while.

According to PitchBook data, Slack raised approximately \$1.2 billion of venture capital financing in ten rounds between 2009 and 2018. Over time, the ranks of Slack's investors swelled to include a number of high-profile firms, including Andreessen Horowitz, Accel, General Atlantic, Kleiner Perkins, and SoftBank.¹⁶ This large amount of external financing allowed Butterfield to rapidly build a large business from scratch.

Metrics

Despite considerable variability in the metrics that venture capitalists use to measure a startup's progress over time, two general themes stand out. First, a startup must sustain high levels of growth to attract venture capital. Second, especially over the last decade, investors in this space have placed less emphasis on a startup's ability to generate profits and cash flow. The operating assumption in many cases appears to be that growth will attract outside capital, which will drive more growth, which, in turn, will entice new or existing investors to provide more financing that will fuel additional expansion. Investors may look more closely at the perceived path to profitability once the startup scales, and worry less about current profitability. This is especially true in industries that are, or are perceived to be, “winner-take-all.” If investors believe that one firm will ultimately dominate a large market, they, in recent years, often have been willing to fund large losses and high rates of cash burn for a considerable length of time. A clear example of this dynamic is Uber. Between 2016 and 2018, the company generated negative \$8.9 billion of free cash flow.¹⁷ During the same period, the company raised \$7.6 billion of equity and another \$4.6 billion of debt.¹⁸ Of course, it is always possible that investors will suddenly decide that growth comes at too high of a cost, as was the case with WeWork, which ultimately had to be bailed out by SoftBank, its largest investor.¹⁹

Ultimately, according to Peter Thiel, the goal of this form of entrepreneurship is to build over time what he calls a “creative monopoly,” or a business that sells “new products that benefit everybody” and generates “sustainable profits for the creator.”²⁰ This stands in stark contrast to a crowded field of competitors, which Thiel argues “means no profits for anybody, no meaningful differentiation, and a struggle for survival.”²¹ The implications, from a metrics perspective, are profound, and we think students should who pursue this path of entrepreneurship should heed Thiel's advice in *Zero to One*:

The overwhelming importance of future profits is counterintuitive even in Silicon Valley. For a company to be valuable it must grow and *endure*, but many entrepreneurs focus only on short-

term growth. They have an excuse: growth is easy to measure, but durability isn't. Those who succumb to measurement mania obsess about weekly active user statistics, monthly revenue targets, and quarterly earnings reports. However, you can hit those numbers and still overlook deeper, harder-to-measure problems that threaten the durability of your business. . . If you focus on near-term growth above all else, you miss the most important question you should be asking: *will this business still be around a decade from now?* Numbers alone won't tell you the answer; instead you must think critically about the qualitative characteristics of your business (emphasis in the original).²²

As of October 2019, Slack had grown its total paid customer base to 105,000 firms,²³ 821 of whom generated at least \$100,000 of annual recurring revenue each,²⁴ and more than 50 of whom individually exceeded \$1 million of annual recurring revenue.²⁵ The firm's platform strategy, with group chat at its core, has driven incredible user engagement. The average user remains connected to Slack for over 9 hours a day and actively interacts with the platform more than 90 minutes each work day.²⁶ Underpinning this strong engagement are a clean user interface and seamless integration with 2,000 standardized enterprise software applications, as well as 550,000 customized ones.²⁷ Fiscal year 2020 revenues are expected to surpass \$620 million, up 55 percent on a year-over-year basis.²⁸ This incredible top-line growth trajectory has come at a high cost: this fiscal year, Slack will likely lose more than \$140 million (estimated non-GAAP operating loss) and burn through over \$80 million in cash (estimated free cash flow).²⁹

Control (Rich vs. Royal)

Generally speaking, successful entrepreneurs in this arena sacrifice "royal" security when they raise outside capital. They do this, however, because they believe the potential "riches" will be much greater if their startups use external financing to scale. In other words, they decide owning a smaller piece of a larger pie is better than controlling a larger piece of a smaller pie.

Despite a few prominent examples of startup founders, such as Facebook's Mark Zuckerberg and Snap's Evan Spiegel, who have used multiple share classes to entrench themselves at their companies' expense,³⁰ most technology entrepreneurs face the very real possibility of being forced out, or at least no longer being the CEO. Here's why: Venture capitalists generally demand considerable influence, if not control, as a condition of their investments. And in practice, once the venture capitalists gain power in the board room, they are not shy about using it. Academic research has shown that roughly 40 percent of founder-CEOs find themselves on the outside looking in within raising just three funding rounds.³¹ To be sure, changing leadership can be the right move, for entrepreneurs and investors alike, if the founder-CEO is not the right person to take the startup to the next level. Still, we believe that most entrepreneurs who end up in a power struggle may see themselves as Steve Jobs and their investors as John Sculley, the former PepsiCo executive turned Apple CEO who notoriously ousted Jobs in 1985 from the company he cofounded. In other words, entrepreneurs tend to put up a strong fight when their vision and authority are challenged, and will not go quietly upon dismissal.

If the "royal" side of the equation is a mixed bag for technology entrepreneurs, the same is also true along the "rich" dimension. Of course, there are iconic technology entrepreneurs worth billions of dollars who enjoy quasi-celebrity status in American culture. And, arguably, the VC-backed technology startup pattern of entrepreneurship offers the greatest potential upside among the models considered in this note. However, we caution MBA students against succumbing to the availability bias. The big winners are a tiny fraction of the overall population of technology entrepreneurs. Founders often pay themselves very low salaries while building their companies. Mainly they do this out of necessity, but the hope of making up for below-market compensation, and then some, during the exit, also usually

plays a role. Sometimes the gamble pays off, but in most cases it does not. Another factor to consider is liquidity. Even if a large payoff does happen at some point, entrepreneurs may not be able to tap the wealth tied up in their ownership stake for quite a while.

And even if the startup achieves tremendous success and eventually goes public, cashing in those gains may not be a simple matter. According to a UBS analysis of data compiled by University of Florida finance professor Jay Ritter, any initial IPO pop in a company's share price tends to dissipate quickly. In fact, between 2000 and 2016, the average six-month absolute return and excess return (relative to the equity market overall) for all U.S. IPOs, the majority of which involved technology companies, turned out to be negative.³² One of the main reasons for this underperformance appears to be the expiration of "lock-ups," which prevent insiders like entrepreneurs and venture capitalists from selling large blocks of stock all at once at the IPO, depressing the share price considerably. Instead, the "cliff" is postponed until an expiration date, typically three, six, or twelve months after the IPO.

On June 20, 2019, Slack went public through a direct listing on the New York Stock Exchange.³³ The share price rose nearly 50 percent on the first day of trading, implying a roughly \$20 billion market capitalization.³⁴ This compared with the \$17 billion valuation implied by private transactions in the secondary market in April 2019 and the \$7.1 billion post-money valuation that Slack achieved during its last venture capital round in August 2018.³⁵ Since Butterfield owns 8.4 percent of the company, he became a billionaire, on paper at least, upon completion of the direct listing. Clearly, when all was said and done, Butterfield had achieved "rich" status.³⁶

Day-to-day activities

Technology entrepreneurs typically spend a considerable amount of time hiring. New additions to the team have a very large impact during the nascent stage of a startup's journey. Getting it right also influences the startup's ability to raise external financing, since angel investors and venture capitalists usually put considerable time and effort into assessing the quality and potential of each key team member.

Pitching potential customers is another key activity for technology entrepreneurs, because investors demand high levels of growth. Spending time out in the market is especially important in enterprise software, where customer education is often required. That said, technology entrepreneurs must be ready to wear many other hats, and no task is too humble during the early days.

Periodically, founders will spend a lot of time and energy on managing their board. And every twelve to eighteen months, most entrepreneurs will be working hard to raise another round of external financing. This process involves not only courting new or existing investors, but also requires entrepreneurs to sell their vision for the enterprise to a variety of other stakeholders, including employees, potential hires, customers, suppliers, and business partners.

Exit

In this form of entrepreneurship, there are two primary means of exit. First, there is "going public." If a startup makes it this far, the people who got in early typically make fantastic amounts of money. This is the exit that technology entrepreneurs dream about.

The other path to exit is a sale. Selling a startup can be a great outcome. For example, WhatsApp sold to Facebook – which felt an emerging competitive threat from the startup – for \$19 billion in 2014, and GitHub commanded a \$7.5 billion valuation when Microsoft acquired the software development platform in 2018.³⁷ However, in some cases, a sale happens when a startup's venture capital backers

begin to doubt that the venture can be a home run. In others, an entrepreneur may look to sell if no additional venture capital can be raised, or it can only be raised on unattractive terms.

Generally speaking, a technology entrepreneur should expect a sale to be the beginning of the end of her tenure at the startup. Strategic acquirers almost always want the founder to stay on for at least a transitional period. Sometimes, they offer the entrepreneur a high-level executive position in hopes that she will stick around for the long term. However, since entrepreneurial people often chafe at the prospect of working for someone else, an arrangement of this sort may work for a while but is unlikely to be sustainable.

Despite the impression created by extensive media coverage of VC-backed technology startups over the last decade, the probability of achieving a huge exit in this field is lower than many have come to believe. Of course, the first hurdle is raising even a seed-stage round of venture capital. Precise data are hard to find, since it is not always clear from the outside when a startup tries but fails to attract seed funding. That said, we can look at the situation from the venture capital firm's perspective as a proxy. As noted above, and according to Alejandro Cremades, a serial entrepreneur and the author of a popular guide to startup fundraising, the average seed-stage venture capital firm will invest in just three or four out of the 1,000 startups it evaluates each year, which is equal to 0.3 to 0.4 percent.³⁸

Tracking the rest of the startup fundraising funnel is somewhat easier. According to a 2018 CB Insights study that tracked 1,119 technology startups that raised seed-stage financing between 2008 and 2010, only 534 (48 percent) of them were able to raise at least one more round of venture capital funding. This is particularly sobering when one considers that the average *successful* startup raises several additional rounds of venture capital, not just one. Of the startups in the sample, 341 had achieved an exit, either a sale or an initial public offering, by early 2018, but the enterprise value achieved was less than \$50 million in roughly two-thirds of the cases. Factoring in the liquidation preferences typically built into the capitalization tables of VC-backed technology startups, this means the founders of those firms likely did not receive life-changing payouts from most of those deals – which were consummated at relatively modest valuations. Only 12 startups achieved a valuation in excess of \$1 billion (i.e., unicorns), roughly 1 percent of the entire cohort.³⁹ One of this group was Slack.

Venture capitalists know that despite their best efforts to pick the winners among a large cohort of startups, they will end up with plenty of losers. As Peter Thiel observed in *Zero to One*:

[V]enture [capital] returns don't follow a normal distribution overall. Rather, they follow a power law: a small handful of companies radically outperform all others. . . . *The biggest secret in venture capital is that the best investment in a successful fund equals or outperforms the entire rest of the fund combined* [emphasis in the original].⁴⁰

Although this point might seem most relevant to an aspiring venture capitalist, we believe would-be technology entrepreneurs in MBA programs should internalize it as well. We wholeheartedly agree with Thiel's assertion that:

The power law is not just important to investors; rather, it's important to everybody, because everybody is an investor. An entrepreneur makes a major investment just by spending her time working on a startup. Therefore every entrepreneur must think about whether her company is going to succeed and become valuable.⁴¹

Lifestyle

The popular perception is that technology entrepreneurs lead an exciting and glamorous life. Some do. The ones who make it big enjoy pharaonic levels of wealth and often become celebrities on par with Hollywood actors.

While achieving this dream may be the goal of many would-be technology entrepreneurs, they should recognize that it is unlikely to become a reality. Nevertheless, great financial outcomes are very possible. And even if a Silicon Valley entrepreneur never becomes extremely wealthy, she can still live a fulfilling life in the beautiful San Francisco Bay Area.

Success, however, almost certainly requires working at a dizzying pace, particularly during the early days. Building a business from scratch, or as Peter Thiel puts it, “going from zero to one,” is extremely difficult. Relentless effort and incredible determination are table stakes in this game.

Intangibles

Arguably, there is nothing like the energy and optimism of a Silicon Valley startup. And, perhaps more importantly for some, being able to say you are a technology entrepreneur carries a lot of weight in many social circles.

Risk

Although this pattern of entrepreneurship, among the six we profile in this note, offers the largest potential upside, it also involves the most risk. Technology risk is a generally one of the main risk factors for entrepreneurs in this field, because so often the primary mode of competitive differentiation is “building a better mousetrap.” No single company, whether the biggest, best-funded industry giant or the scrappiest and hungriest startup, has a monopoly on innovation, and the competition for top engineering talent in Silicon Valley is fierce. As a result, it is a daunting proposition for a fledgling venture to out-innovate both large incumbents and rival startups. In addition, innovation in one portion of the technology sector does not occur in a vacuum. A new approach developed by another player in a different part of the broader ecosystem can render obsolete existing technologies and business models for a wide range of firms, even if they are not direct competitors.

Another major source of risk is business model risk. In many cases, technology startups try to deliver “cheaper, faster, and better” through an entirely new business model, as well as technical innovation. This is particularly daunting, because there is no established “core” business to fall back on. Either the founding team captures a lightning in a bottle, technologically and commercially speaking, or the venture fails entirely.

During the early stages of a technology startup’s journey, execution risk is thoroughly intertwined with financial risk. The reason is that the entrepreneur must execute sufficiently well, as measured by the various metrics we outline above, in order to secure additional funding. If external providers of capital believe that the startup cannot demonstrate not only traction but the potential to achieve “escape velocity,” in Silicon Valley parlance, the funding spigot will shut off more quickly than most would-be entrepreneurs generally realize. In other words, a startup’s cash burn in the pursuit of growth is only sustainable as long as venture capitalists stand ready to bankroll the venture, because there is no safety net provided by internally generated cash flows.

Cool branded consumer products

In recent years, many MBA students have looked to the consumer products space for entrepreneurial opportunities. A few have even achieved tremendous success less than a decade after graduating. Wharton alumni Neil Blumenthal, Andrew Hunt, Jeffrey Raider, and David Gilboa co-founded Warby Parker, an online retailer of branded prescription glasses and sunglasses.⁴² Katrina Lake started working on Stitch Fix, an online personal styling company, during her second year at Harvard Business School.⁴³ And then there is Andy Katz-Mayfield, a Stanford GSB graduate who teamed up with Warby Parker's Jeffrey Raider and launched Harry's, a digital-native brand of shaving and skin care products.⁴⁴

Four major trends have created an opening for consumer startups to challenge large incumbents in this space. First, millennials have entered their prime years as consumers, and decades-old brands have struggled to win their business.⁴⁵ Second, e-commerce has fundamentally disrupted traditional retail channels for consumer products. Third, consumer preferences have changed, with more Americans wanting natural, organic, and/or artisanal foods and packaged goods. Fourth, the internet has given rise to new, and arguably more effective, ways for companies to market their wares to consumers.

The ambitions of startups in the branded consumer products industry varies considerably from firm to firm. Some have set their sights on achieving on a national or even global scale, while others look to carve out a niche at the local or regional level.

One example of the latter is Smitten Ice Cream (Smitten), a premium, fresh-churned ice cream chain with five locations in the San Francisco Bay Area. Founder Robyn Sue Fisher conceived of the idea for the venture while earning her MBA at the Stanford Graduate School of Business (GSB). For Fisher, business school was a means to pivot from management consulting, which she had done for four years after graduating from Williams College, to entrepreneurship. Ice cream spoke to her as an opportunity for two reasons. First, she loved the dessert, and she used to eat it regularly as a small reward for long days and nights spent at the office. Second, and more importantly, she drew a parallel between the lack of innovation in the product category and the revolution in coffee over the last several decades. In an interview with Stanford's Center for Entrepreneurial Studies, she explained:

I thought that there had to be a way to scale fresh ice cream. So I dove my team into ice cream to see if we could improve the category. We realized there was so much that was broken that needed fixing—the category was really in the “Ice Age” when it came to keeping up with consumer expectations in other categories and evolving trends. Just like coffee evolved from Folger's in a can to a freshly made latte with newly ground beans, ice cream needed a fresh revolution.⁴⁶

Robyn spent most of her second year at Stanford working on her idea. After graduating in 2007, she worked various contract jobs for the next two years as she focused on developing a new type of quick-frozen, fresh-churned ice cream, and the even greater challenge of inventing a machine that could produce it reliably and efficiently. She and a retired aerospace engineer ultimately found a solution and patented the equipment. Then Robyn went to work selling small batches of ice cream on the streets of San Francisco, pulling a red Radio Flyer wagon behind her. Consumer demand was robust right from the beginning. In 2011, Robyn opened her first Smitten Ice Cream store in the Hayes Valley neighborhood of San Francisco. New locations sprouted up in other parts of the Bay Area over the next few years. By 2018, Smitten had opened nine stores, including a few in the Los Angeles metropolitan area.

Barriers to entry

Arguably the highest barrier to entry for a startup in this space is the brand awareness and loyalty that incumbents enjoy. In some cases, the incumbents have invested billions of dollars in their brands over decades. For a startup to be successful, it has to find a way to build a brand identity that resonates with consumers and convinces them to try an alternative. Of course, a lower price can help incentivize customers, but that risks diluting the brand investments that the startup makes.

The other primary barrier to entry is distribution. In the many consumer products categories that earn small contribution margins, gaining scale is the only way to cover fixed costs. The problem for a startup is that scale requires distribution, but investing in distribution channels might be impossible without the financial resources that scale provides.

Over the last decade, the internet has significantly lowered these barriers to entry. First, e-commerce has grown substantially in size and scope. Simply put, more American consumers are spending larger amounts of money on wider range of goods from online retailers than ever before. Since consumers have embraced the internet as a means of buying what they want and need, shelf space in brick-and-mortar stores, long a competitive moat for incumbents, has become less important. Second, the internet does a better job than traditional media in delivering the right advertisement to the right person at the right time. In addition to improved targeting, online advertising has the potential of virality, which means a marketing message can spread far beyond its initial audience at no additional cost to the brand. For their part, incumbent consumer products companies – long accustomed to optimizing their advertising efforts for television, have been relatively slow to harness the internet to reach new and existing customers, ceding valuable ground to forward-thinking new entrants.

Key differentiator

The key differentiators in this space are either tangible (i.e., better quality, more features, etc.) or intangible (i.e., brand). However, we would argue that the intangibles are more important for two reasons. First, in many categories, competing products are so similar that most consumers cannot distinguish one from another without the help of packaging. Second, and more importantly, a brand allows the producer to command a price premium above and beyond the value of any tangible differences that exist.

Fisher made use of both forms of differentiation to set Smitten apart in a highly competitive market with many alternatives, both at-home (e.g., Dreyer's, Ben & Jerry's, and Häagen-Dazs) and in-store (e.g., Baskin-Robbins, Dairy Queen, and Cold Stone Creamery). A customer walks into a Smitten store and orders from a highly curated selection of ice cream flavors made from artisanal ingredients and without chemicals or artificial preservatives. Only then, with a specially designed machine that uses liquid nitrogen for quick freezing, does a *Brrrista*®, whose role is comparable to that of a Starbucks' barista, prepare the ice cream.⁴⁷ The result of this process is a distinctive frozen treat that is smoother and creamier than other ice cream options. Smitten's branding is modern and minimalist; quality, not quantity is the focus; and price points are high.

Path to going concern (Product-market fit)

In some cases, the path to a going concern for cool branded consumer products startups is similar to that for VC-backed technology companies, because some new entrants in the space also have raised significant amounts of venture capital. For example, Warby Parker⁴⁸ took in nearly \$300 million of venture funding between 2010 and 2018, while AeroFarms, a New Jersey-based indoor farming company that sells produce under the Dream Greens brand at Whole Foods, closed a \$100 million financing round in July 2019.⁴⁹ Like her Silicon Valley counterpart, the cool branded consumer products

entrepreneur must think, first and foremost, about setting and achieving milestones that will allow her to raise additional external financing. Usually, this means stepping on the gas to drive revenue growth.

Other cool branded consumer products startups, typically less capital-intensive ones, follow the same path as most small businesses. In these cases, the entrepreneur often sacrifices some growth to build a foundation that can generate profits and cash flow. With the knowledge that the basic model works, she then seeks outside funding to fuel further expansion.

Fisher took a hybrid approach at Smitten. During the first couple of years, funding for the business largely came from Fisher, her family, and her friends.⁵⁰ Then, in 2009, when she wanted to open her first store, she raised a modest \$460,000 of financing from angel investors. Once the first store opened in 2011, she raised another \$800,000, just enough to allow her to focus on getting the model right at the sole location.⁵¹ This decision allowed her to create a business whose unit economics compared favorably with those of an average shop for a national chain. Because Smitten commanded premium pricing for its wares, annual per-store revenues reached \$1 million, compared with just \$300,000 for the average location of a large-scale competitor.⁵² Better revenue productivity more than offset the higher labor and rent expense of operating in the expensive Bay Area. The result was Smitten's operating margin came in around 30 percent, triple the 10 percent level achieved by the average scoop shop.⁵³

With a solid foundation in place at one store, in 2012, Fisher raised \$2.5 million of seed-stage venture capital to drive growth.⁵⁴ Store openings averaged approximately two a year between 2011 and 2016.⁵⁵ The next financing came in 2018, when she closed a \$3.1 million round.⁵⁶

Metrics

The key metrics vary across this form of entrepreneurship. However, generally speaking, unit economics are top-of-mind. Product costs, shipping expenses, utilization rates, store productivity, return on marketing investment, and capital intensity all receive considerable attention from management. For subscription models, customer acquisition costs and lifetime value are arguably the most important variables. And as mentioned earlier, the startups who receive large amounts of venture capital funding are likely to prioritize top-line growth. Some of these firms also will closely track market share trends using third-party data from the likes of Nielsen.

Control (Rich vs. Royal)

There is a wide spectrum when it comes to control. Fantastic riches are certainly achievable. For example, according to *Forbes*, Katrina Lake, founder and CEO of Stitch Fix, was worth \$380 million, as of mid-2019.⁵⁷ The Bishop family, who founded Blue Buffalo, a premium pet food company, enjoyed a \$625 million payday when General Mills bought the business for \$8 billion in 2018.⁵⁸ Despite these examples, we believe that the potential upside in consumer products is lower than in the tech sector. The reason is simple: Software businesses, at scale, have the potential to earn larger profits and higher returns on capital than consumer goods firms. That said, the probabilities, not the absolute payoffs, dominate the expected value calculations, in our view.

The "royal" side of the equation varies depending on the entrepreneur's ambitions for her startup. If she needs lots of external venture capital to scale the business, she likely will have to sacrifice control. On the other hand, if she can rely primarily on her own resources or the startup's internally generated cash flows, which is more likely at a relatively smaller scale, she probably can maintain control well into the future.

Fisher represents an interesting point along the “rich and royal” spectrum. With five locations, as of early 2020,⁵⁹ that generate solid cash flow, she does not need to worry about money. In all likelihood, the business will be able to produce an annuity-like income stream for quite a while. And if Smitten remains at the scale of a local or regional chain, Fisher probably will have a good chance of leading the company for as long as she wants.

Day-to-day activities

No two days are the same for an entrepreneur in branded consumer products. Some days will involve getting deep in the weeds of the operations, while others will allow for “big picture” strategic thinking. Early on, most of the entrepreneur’s time and energy will be spent on working with suppliers, managing production, putting in place distribution infrastructure, and building brand awareness.

Fisher has played every role at Smitten. She has scooped ice cream, secured venture capital financing, and everything in between. Over time, as the business has expanded, she has been able to take a step back from working shifts in the stores to focus her efforts on working on the business.

Exit

An IPO is certainly possible, as Stitch Fix demonstrates, but a sale to a large incumbent, consumer packaged goods (CPG) company is probably more likely. The reason is that many of the established CPG players have tried to jumpstart sluggish top-line growth through acquisition. Examples of these growth-motivated transactions include Shiseido’s \$845 million purchase of Drunk Elephant, a youth-oriented, natural beauty products brand, in 2019,⁶⁰ Nestle’s \$500 million deal for a 68 percent stake in Blue Bottle Coffee in 2017,⁶¹ and Unilever’s \$1 billion acquisition of Dollar Shave Club in 2016.⁶²

As of 2019, Fisher seems in no rush to achieve an exit for Smitten. Whenever an exit does occur, however, a sale is almost certainly going to be the form it takes.

Lifestyle

Like other entrepreneurs, founders of cool branded consumer products companies work very hard. The early days will be filled with endless demands on the entrepreneur’s time and attention. As the business scales, a better work/life balance is achievable.

A key variable will be whether the startup requires venture capital to achieve the desired scale. If the entrepreneur wants to build a large company, she likely will need to trade control of the venture, as well as some amount of independence in her lifestyle, for a substantial amount of money from venture capitalists. On the other hand, more modest ambitions for the startup probably will allow her to have greater control over the business and to strike a better work/life balance.

For her part, Fisher enjoys a great life in San Francisco. Reflecting on the difficulty of getting Smitten off the ground, she told Stanford’s Center for Entrepreneurial Studies, “Those were long, hard days, but I’m thankful for them, because they helped me to establish the culture and values of the company.”⁶³

Intangibles

As the name of this form of entrepreneurship suggests, there is a certain social cachet that comes with starting a new venture in the consumer products space. But that is not the only intangible involved here. For example, food entrepreneurs, including Fisher, take great pride in selling natural, wholesome

products that customers love. And, of course, many founders in this space can enjoy the unique experience of walking into a store and seeing their products on the shelves.

Risk

We believe that the cool, branded consumer product startup is the second riskiest pattern of entrepreneurship among the six that we profile in this note. For starters, this type of venture is inherently built from scratch, so there is no established “core” business that provides a financial backstop during the initial phases of development. If the entrepreneur relies on venture capital to fund her startup, then she will face a similar dynamic to her Silicon Valley technology counterpart: Raising additional capital depends on execution against progressively higher performance targets.

Arguably the greatest risk factor in this pattern of entrepreneurship is the fickleness of consumer taste. As the term “cool” implies, startups in this space must convince consumers that new brands have value as a signal of real or perceived quality, a status symbol, or both. Although the internet, social media, and mobile devices have provided new channels to market products to consumers, many of the old challenges of brand-building remain. Some startups have proven quite adept at building brand awareness and brand equity through digital media, but most have not. Given the low barriers to entry in the consumer products industry, it is not surprising that the competition for consumers’ attention is fierce, from large incumbents such as Procter & Gamble as well as rival startups.

Boring and basic, bootstrapped, copycat models

Entrepreneurship need not involve cutting-edge technology, revolutionary marketing techniques, or even an attention-grabbing product or service. In fact, we would argue that majority of the 433,000 new businesses started in the United States in 2016, the most recent year for which data were available, lack these characteristics.⁶⁴ The entrepreneurs who launch these “boring and basic” ventures aim to build businesses in an already established industry, typically one that provides unglamorous but essential products or services. In doing so, this type of entrepreneur clearly bets on her ability to create a new company from scratch. What she generally does not do, however, is take business model risk. Her strategy depends on carving out a position in a proven market. Since she is not attempting to disintermediate or disrupt a market, the entrepreneur tends to differentiate her company by offering products or services that are better, faster, and/or cheaper than the alternatives sold by incumbents. It is for the same reason that capital requirements for the new venture are likely to be manageable. In most cases, the entrepreneur will be able to self-finance the endeavor, or raise modest amounts of startup capital from family, friends, or the local community.

To some degree, this form of entrepreneurship can be thought of as “copycatting” what already works. However, we would caution against this. “Boring and basic” startups can succeed for a variety of reasons over the long run. Among other strategies, they can come up with a new twist on an existing model, bring an established concept to a new geography, or simply carve out a share of a mature market for themselves. The key is for the new venture to have some type of hook that convinces customers to buy from it instead of rivals. That said, the amount of creativity and innovation in the “boring and basic” category tends to be modest relative to that observed in the previous models we have explored entrepreneurial arenas.

Scaling a “boring and basic” startup nevertheless requires many of the same skills and involves many of the same activities as flashier ventures. An entrepreneur in a “boring and basic” industry still must manage people, architect an organization, sustain consistent levels of operational execution, seek out

new business, and expand the scope of relationships with existing customers. As a result, the work can be just as thrilling and downright fun as a leadership role at a more glamorous startup. In short, it would be a mistake to confuse the excitement and satisfaction of an entrepreneurial pursuit with the “sexiness” of the actual product or service that the business provides.

Generally, the goal of a “boring and basic” startup is to establish a sustainable business for the long run. As a result, the eventual scale of the enterprise might only be local or regional, rather than national or global. Success might be measured in millions or tens of millions of dollars in annual revenues, not billions. The entrepreneur will aim for long-term value creation through free cash flow generation and the gradual build-up of equity.

There are endless examples of happy and wealthy entrepreneurs in the “boring and basic” category. You might even know some yourself without realizing. They are often the anonymous “millionaire next door” types popularized by Thomas Stanley and William Danko’s book by that title.

An example of this type of entrepreneur is Eric Zipkin, the founder and CEO of Tradewind Aviation, a Connecticut-based operator of on-demand private and scheduled charter flights throughout the United States and Caribbean.⁶⁵ Zipkin, who earned an undergraduate degree from the Wharton School at the University of Pennsylvania in 1995, started his career in residential and commercial real estate. However, he soon pivoted to aviation. His first role in the industry was as a charter sales representative for Westchester Air. He then became a pilot for charter aircraft. From these experiences, Zipkin learned the inner workings of the chartered flight business. In 2001, he teamed up with his brother David to launch Tradewind Aviation with one airplane. In a few years’ time, Tradewind started selling single seats on scheduled shuttles. This strategy expanded the firm’s addressable market, because customers no longer had to bear the substantial cost of chartering an entire plane when purchasing transportation services for just one or a handful of passengers. The company added new planes to meet the demand and gradually started flying to more and more destinations.⁶⁶

As of 2019, Tradewind has grown into a \$40 million business through sweat equity, retained earnings and regulated bank financing. It operates a fleet of 25 aircraft and employs nearly 200 people. During the summer season, Tradewind makes 30 to 40 flights a day to Nantucket alone. Roughly 70 percent of the company’s total flights are shared, with the remaining 30 percent being private.⁶⁷

Barriers to entry

“Boring and basic” businesses tend to see low barriers to entry. Most entrepreneurs who take this path bootstrap their ventures and have an experimental mindset of testing and seeking validation before attempting to scale. The initial foray will certainly require some capital, but the entrepreneur does not seek to enter a market with complete infrastructure and the ability to accommodate very rapid growth. Large quantities of capital are not required to tiptoe into a business with modest initial ambitions.

For Zipkin, this meant at first leasing a single airplane, renting limited hangar space and piloting the plane himself – not attempting to build a fully formed charter flight business at the beginning. Once Zipkin got some traction and proved to himself, and the market, that his business was indeed viable, he added a second plane and repeated the cycle. Growth over time was gradual, organic, and methodical.

Key Differentiator

In “boring and basic” businesses, entrepreneurs tend to differentiate by focusing on one or a few of the factors that determine customer purchase behavior. For example, if customers in the industry care most about delivery speed when selecting a vendor, the “boring and basic” entrepreneur will invest heavily in the firm’s logistics capabilities.

When the Zipkin brothers formed their new company, they were not disintermediating or disrupting a market. They were entering a well-established, decades-old industry with compelling economics. There were several keys to Tradewind’s ability to differentiate. For starters, it carved out a geographic niche, focusing solely on the Northeast United States in the early days. Tradewind also cut costs by basing its operations outside of New York City. By locating in less-expensive Oxford, Connecticut, the firm could still serve the lucrative nearby metropolitan market. From the beginning, Tradewind also was capital-light, by aviation industry standards, and over time Zipkin has leased, not owned, most of the aircraft the company operated. The labor cost structure also was flexible, for Zipkin relied on a mix of pilots who were full-time employees and others who were independent contractors. Tradewind also operated better aircraft and strove to provide a higher level of in-flight service.

Path to going concern (product-market fit)

This path of entrepreneurship is all about quickly attracting profitable customers. The “boring and basic” entrepreneur is not establishing or defining a new market. In most cases, she is merely trying to convince customers who are currently using an existing vendor to switch to the new venture. Since this generally requires the execution of a “cheaper, faster, better” strategy, the entrepreneur needs to be careful not to do too much before getting a handle on the costs involved in providing a narrow range of products or services.

If the “boring and basic” entrepreneur is establishing a new business in a geography where the product or service is not widely available, she might focus on attracting customers with limited knowledge of or familiarity with the offering. In some ways, this option is more challenging than seeking customers who will be switching vendors, because educating a marketplace can be expensive and slow. On the other hand, the advantage of attracting unvetted customers is that there is not a requirement to offer a price incentive for switching.

Metrics

Since “boring and basic” startups usually do not require large amounts of externally provided equity capital, entrepreneurs who take this path likely will have a fair amount of discretion over defining what constitutes success. That said, the goal remains building a viable business, so early on, most “boring and basic” entrepreneurs will focus on pricing and costs, as well as measures of customer acquisition and retention, such as the number of meetings with prospects, the volume of proposals made, time to close, win rates, and renewals. Over time, there will be a gradual shift in priorities from expansion to sustainable cash flow generation and the long-term compounding of equity value. Generally speaking, a prudent business leader of this sort will drive profitable growth, rather than succumbing to the temptation to grow for growth’s sake. Managing cash flow will also matter on a day-to-day basis, because there is generally no safety net provided by institutional venture capital firms, as there might be for a technology or cool CPG startup that runs low on funds.

Non-financial measures of success also could play a role for this type of entrepreneur. It is not uncommon to find “boring and basic” businesses that emphasize customer satisfaction, employee happiness, community involvement, and company reputation.

Control (Rich vs. Royal)

Many would-be entrepreneurs find this model appealing specifically because they want to be, first and foremost, royal, and, to a lesser degree, rich. “Boring and basic” entrepreneurs tend to hold controlling equity positions in their businesses by choice. Still, it is also true that many early-stage providers of capital, such as angels or VCs, are reluctant to invest in these companies because their lower growth profile usually translates into lower returns, at least in the short run.

Having a high degree of control allows the “boring and basic” entrepreneur to steer the enterprise in the direction she sees fit. In most cases, there is no external pressure to scale the business at a certain pace, so the entrepreneur can drive growth as quickly or as slowly as she can or desires. There is typically no need for time and energy spent on managing board dynamics or equity partners. And while the business will crave time and attention in the early days, the entrepreneur generally can achieve a desirable work/life balance once the company gains its footing.

“Boring and basic” entrepreneurship offers a large degree of control, but it also offers the possibility of building considerable wealth over time. That said, an entrepreneur following this path is unlikely to earn a lottery-like payoff. Control of a “boring and basic” company might yield millions or tens of millions of dollars, which is a great outcome, even if it is not the hundreds of millions or billions for which technology and cool CPG entrepreneurs will play and generally sacrifice “royal” benefits.

Day-to-day activities

The expression “chief cook and bottle washer” adequately sums up the day-to-day workload involved in the “boring and basic” enterprise. In the startup phase, the venture’s success largely will be a function of the entrepreneur’s grit and sheer will to move the business forward. An appropriate image is an entrepreneur pushing a big boulder up a hill. Resting, even for a short while, could result in the boulder rolling back on the aspiring entrepreneur. It is only through relentless effort that the company will gain traction and tenability. During this phase, the entrepreneur will establish systems and procedures, but she will spend most of her time attracting customers. Anyone who did not learn about sales in business school will quickly become a master when building this type of business.

As the business gets a bit bigger, the entrepreneur might shift from doing activities to managing activities. That said, the entrepreneur will likely still spearhead customer acquisition, especially in smaller “boring and basic” businesses. In addition, her day probably will involve a fair amount of work related to cost containment. Capital structure and corporate strategy might be revisited on a yearly or triennial basis, but they will not consume her thoughts on a weekly or monthly basis.

Human capital issues will be a major commitment as soon as employees join the team. Recruiting and managing people often takes more time and effort than most “boring and basic” entrepreneurs expect.

A “boring and basic” entrepreneur should be prepared to work *in* the business on mundane and non-value-added activities (e.g., procuring office supplies) and *on* the business in value-creating activities (e.g., winning large recurring customers). She needs to be prepared to zoom into the most granular details of the business (e.g., delivery routes) and zoom out to formulating the overall strategy (e.g., determining which customer segments are the most attractive, and why).

Exit

Since the goal for virtually all “boring and basic” entrepreneurs is to build wealth over decades or even generations, initial public offerings involving these businesses rarely happen. Wealth creation primarily occurs gradually over time through the accumulation of free cash flows and equity. Bank refinancings and dividend payments can provide liquidity in the meantime, assuming, of course, that the business eventually generates ample cash flows. Opportunities to sell, either to strategic acquirers or private equity sponsors, often present themselves, if the “boring and basic” company achieves a certain size. However, in some cases, “boring and basic” entrepreneurs become so emotionally attached to their businesses that they might never consider seriously the possibility of realizing value through an outright sale.

Lifestyle

Once a “boring and basic” business is proven and achieves some scale (perhaps \$1 million in EBITDA), it can provide a wonderful life for the entrepreneur. This path offers a high degree of flexibility. To be sure, she will still work hard, but she likely will be able to do it on her own schedule and in her own way.

Intangibles

This entrepreneurial path can be highly rewarding. It allows the entrepreneur to use all her creative energy and skills while leading and building an emerging enterprise that reflects her values. It often enables the entrepreneur to retain control as the business grows in a gradual, but methodical, manner. It may also offer enhanced opportunities to achieve a favorable work/life balance. Perhaps the only downside of this form of entrepreneurship is that it likely will not land her on the cover of *Wired*.

Risk

A “boring and basic” entrepreneur faces a considerable amount of risk in certain respects but not much in others. Arguably the largest source of risk stems from the need to build a business from scratch. With no established “core” operations that make the firm a going concern from the outset, there clearly is a “sink or swim” element to this pattern of entrepreneurship, not dissimilar to that in VC-backed technology or cool brand consumer products.

However, in some ways the risk involved here is a lot lower than in “sexier” entrepreneurial paths. For starters, in most cases, a “boring and basic” entrepreneur takes very little technology risk. As the “boring and basic” moniker implies, success does not depend on technological breakthroughs and radical innovation. Similarly, there is not much “cool” factor here, for customers primarily care about “better, faster, cheaper” – not styling or brand name. The business model risk also tends to be fairly modest, since “boring and basic” firms operate in well-established, if not mature, industries. This means that the business model has, for the most part, already been figured out by someone else.

Where risk starts to creep back into the equation, however, is execution. The “boring and basic” entrepreneur still must work very hard and tightly manage costs to take the existing model, with or without any new twists, and actually produce good results in the context of her own company.

Franchisee

An often-overlooked path to entrepreneurship for MBA students is to pursue a career as a franchisee. Franchisee operators participate in a franchise system where a brand, systems procedures, and processes are already established. Being a franchisee mitigates many risks associated with being a startup entrepreneur since there is a proven model in place that has worked for other franchisees in other geographic markets. This path also provides an answer to the most vexing question that aspiring entrepreneurs face: What business should I be in, and will it actually work? In franchising, the franchisee entrepreneur focuses on execution and leaves the ideation to the franchisor.

Despite its low profile in American business school curricula, franchising is big business in the United States. According to a PricewaterhouseCoopers (PwC) study, in 2016, franchised businesses operated 801,000 establishments across the country, representing 2.3 percent of all non-farm business establishments. Franchised businesses employed almost 9 million people, generated \$868 billion of sales, and accounted for 3.4 percent non-farm private sector gross domestic product (GDP).⁶⁸

Although many people associate franchising solely with quick-service restaurants such as McDonald’s (13,226 U.S. franchised stores),⁶⁹ Dunkin’ Donuts (9,499 U.S. franchised stores),⁷⁰ and Taco Bell (6,161 U.S. franchised stores),⁷¹ franchising touches a wide range of industries. The UPS Store, a franchise concept built around packaging, shipping, and other business services, has 4,819 locations in the United States.⁷² Ace Hardware, a hardware and home improvement chain, has 4,386 U.S. franchised stores, compared with just 133 company-owned outlets.⁷³ Education and tutoring company Kumon Math & Reading Centers has 1,537 franchised locations in the United States, as well as a staggering 24,719 locations abroad.⁷⁴ And Jiffy Lube, an automotive quick oil change concern, has 1,927 U.S. centers.⁷⁵

Being a franchise entrepreneur has elements of being a “boring and basic” entrepreneur and buying a business as a path to entrepreneurship. Like her “boring and basic” counterpart, the franchisee entrepreneur typically enters a market that is well-established, using a business model proven by others to work. At the same, like the search fund entrepreneur, the franchisee entrepreneur exchanges money for a business to run. For the franchisee, this can take two forms. First, the franchisee can acquire an existing going concern from another franchisee. Second, the franchisee can pay an upfront franchise fee to the franchisor for the right to build an operation using the franchise system’s “playbook.”

Elizabeth (Liz) Roberts is an example of a successful franchisee. After graduating with her B.B.A. from Babson College in 2006, Roberts worked for FTI Consulting for two years. She then transitioned from consulting to finance in 2008 by taking a job with a wealth management firm in western Massachusetts. Roberts enjoyed her four years with the firm, but she decided to search for other opportunities when she became pregnant with her first child in 2012. Entrepreneurship had long been an interest of hers, so shortly after her son was born, she teamed up with another new mom to launch a local, organic baby food company. The duo ultimately abandoned the venture, a move that allowed Roberts to investigate some other ideas she had for new businesses.

By 2013, Roberts and her husband Frank had welcomed a second child to the family. This life event strengthened her resolve to find an entrepreneurial opportunity that would challenge her professionally but also accommodate her desire to “not put the kids in daycare from 7 am to 7pm.”⁷⁶ Serendipity then

entered the picture. Long a fitness enthusiast, Liz attended a class at a barre studio in Wellesley, Massachusetts. Barre, an increasingly popular exercise method that made use of a ballet barre in a gym setting, turned out to both a great workout and an interesting business idea, for Liz had visited the thriving Wellesley location of Pure Barre. A barre studio franchise concept with approximately 250 locations in 2013, Pure Barre had developed a passionate following in Greater Boston, but had not yet extended into western Massachusetts, where Liz made her home. On the ride back from Wellesley, Liz was so excited that she requested additional information from the Pure Barre franchisor.

Further research into Pure Barre revealed that becoming a franchisee in western Massachusetts could be a great opportunity for Roberts. She took the plunge in 2014 and opened her first studio in Northampton, Massachusetts in mid-2015. By late 2019, through hard work and determination, Roberts had grown her business, Red Bird Fitness, to become an owner and operator of eight Pure Barre studios in Massachusetts and Connecticut, with a ninth scheduled to open in early 2020. Across the portfolio, revenues have achieved a \$3 million run-rate, including contributions from two struggling studios that Roberts, with a turnaround plan, acquired from another franchisee. Headcount exceeds 100 employees, most of whom are part-timers. Perhaps most impressive of all, she has done all this in less than half a decade and with three children under the age of 5 at home.

Although most franchisee entrepreneurs have a handful of units in their portfolio and operate at a level similar to Roberts, there are exceptions who own hundreds of locations. One example is Roland Sponberg, a southern California businessman, has built a veritable quick-service restaurant empire since pivoting from real estate development to franchising in the late 1980s. After more than 30 years in business, his holding company, WKS Restaurant Group, owns and operates 192 restaurants in 11 states, and employs more than 5,500 employees. Sponberg initially found success with El Pollo Loco, a Mexican-style chicken concept, and he is the largest franchisee in that entire franchise system. Gradual expansion over time went far beyond El Pollo Loco, however. He is also the largest franchisee in the Krispy Kreme Doughnuts system, as well as the largest California franchisee of Wendy's, the hamburger chain famous for its square patties and baked potatoes. Rounding out his portfolio is a smattering of other concepts, including Denny's (an American diner-style restaurant), Blaze Pizza (a fast-casual chain that does for pizza what Chipotle Mexican Grill does for burritos), and Corner Bakery (a modern take on the traditional bakery café).⁷⁷

Barriers to entry

Being a franchisee entrepreneur requires capital. There is no way to bootstrap your way into this path. To have the right to operate a franchisee you will have to pay franchise fees to the franchisor. According to Franchise Direct, an online research platform for franchising, these fees vary considerably across franchise systems, from less \$10,000 all the way up to \$1 million, with most falling somewhere \$20,000 and \$50,000.⁷⁸ However, there is even more variation than this suggests, for many franchisors adjust the fee depending on certain factors, such as the type of location and whether it is newly built or acquired. For example, the franchise fee for the UPS Store ranges from \$9,950 to \$29,950.⁷⁹ 7-Eleven takes a different approach: The franchise fee it charges is actually a function of the store's gross profit and can range from \$100,000 to \$1 million.⁸⁰

The initial investment required to become a franchisee includes much more than just the franchise fee. These other startup costs are associated with the actual establishment and operation of the franchise location. Again, there is considerable variation across franchise systems and within them, but generally the total capital required ranges from a few hundred thousand dollars to more than \$2 million. For example, Jiffy Lube franchisees typically need to budget between \$200,000 and \$425,000 per oil change

center.⁸¹ On the other hand, becoming a McDonald's franchisee requires approximately \$450,000 for a small-format location but \$2.2 million for a traditional, full-size restaurant.⁸²

Additionally, franchisors require franchisees to apply for participation in a franchise system. Typically, there are net worth requirements, liquid asset requirements, and possible experience requirements in order to be granted a franchise. The franchisee approval process also takes time. In some cases, it can take a matter of months, but in other cases, it can take years. Generally speaking, newer, less well-known franchise systems have lower requirements to gain entry, but the most successful franchise systems are a challenge to enter. Beyond the franchise approval process, there is additional time required to rent or construct space and build out the location.

For Roberts, like most new franchisees, the biggest challenge to getting into the arena was scraping together startup capital. She made a big bet on herself, emptying her retirement account, taking zero-percent credit card loans, and borrowing from friends and family. However, she took this risk only after developing a 15-year business plan based on conservative assumptions that she gathered from existing franchisees in the Pure Barre system. Each new studio required \$250,000 of upfront capital. Once membership ramped up to steady-state at the location, annual revenues of \$350,000 to \$400,000 were achievable. Royalties and marketing expenses payable to the franchisor would consume 8 percent of gross sales. Monthly EBITDA, with some seasonal variation, came in between breakeven and \$10,000, with strong-performing studios generating \$8,000 to \$10,000 on a consistent basis. Of course, some locations run negative EBITDA, especially if a studio is in turnaround mode. Ongoing capital expenditures were fairly low, and exit opportunities appeared reasonable, if not attractive, since low-to-middle-market private equity sponsors had become interested in the fitness space in recent years. Altogether, these factors made for a compelling investment opportunity. The approval process to join the Pure Barre system consumed a number of months, and building out a new studio took a few more.

Key Differentiator

The key differentiator in the franchisee world is to not differentiate at all. Being a franchisee entrepreneur is more about compliance and execution than innovation and creativity. Franchisors will provide franchisee operators with detailed sets of rules and systems to follow. Sticking to these processes and procedures, which are often the product of years of testing and refinement, are what makes franchisees successful.

Since the franchisor develops and manages the franchise concept, it is not inaccurate to think of the franchisee as paying upfront franchise fees and ongoing royalties in exchange for “a business model in a box.” However, conceiving of a franchisee in this way risks downplaying the fact that she still owns and operates her own business. A franchisee, unlike some other types of entrepreneurs, may not have created the playbook for success, but her success hinges on the ability to execute. It takes a certain type of entrepreneur to accept this dynamic, where ownership of the business does not involve ownership of the business model. According to Roberts:

As a franchisee, you're an entrepreneur, since you own the business. The catch is you still have to play by someone else's rules. For me, that tradeoff works. The franchisor is never going to run your business for you, and if you want to succeed, you still have to get in there and do the work yourself. Independence does not mean isolation, however. The franchisor has a lot of smart people who want the franchisees to succeed, and I can always ask them questions and get a big picture view of what's going on across the [franchise] system. Of course, since the franchisor is not down in the weeds of the operations day-in-and-day-out, the advice that comes back

sometimes doesn't jibe with the reality for a franchisee on the ground. A franchisee must roll with that. You have to understand that in situations where these differences of opinion do arise, it's usually because the franchisor cares most about the top line, but the franchisee cares most about the bottom line. Not everyone can handle all that.

Path to going concern (product-market fit)

In theory, the most desirable part of being a franchisee entrepreneur is the probability of building a successful going concern. As Spongberg put it in an interview with the *Los Angeles Times*:

There's a great opportunity in franchising, to be a franchisee. It has very little failure. If you look around at any kind of restaurants that are branded, McDonald's, El Pollo Loco, Denny's, a few fail, but not many. So you've got lower risk. You've got a way better chance of making it. You've got people that are ready to finance you because you have the brand, the backing.⁸³

These better odds of "making it" are primarily a function of the franchisor's brand, systems, processes, and ongoing support. That said, the peer franchisee community also offers a helping hand. Roberts explained that when a new franchisee joins a franchise system, "you're joining a community of owners, as opposed to being completely on your own as an entrepreneur." In fact, franchisees often find that the best help and advice comes not from the franchisor but from their fellow franchisees. The arc of Roberts' own experience with Pure Barre illustrates the power of this tight-knit network:

When I first joined the franchise system, I was very welcomed by the other franchisees. Most of them are other women, many are also moms like I am, and they all have been through the franchisee experience with Pure Barre. Franchisees want to help each other out, and I can always reach out to them. I've also been able to pay it forward by serving as one of six members on the President's Council, a representative body that advises the franchisor on franchisee issues. Now that I have this role, new and existing franchisees email me for help and suggestions. I'm happy to do what I can, because it wasn't long ago that I was in their shoes.

Although there are certainly reasons to believe that franchisees have higher chances of success than other entrepreneurs, the reality is more complicated. Failure rates for new franchisees vary greatly across concepts. In some franchise systems, there are few failures, while in others, failure rates can be as high as 80 to 90 percent.⁸⁴ Pinning down exact numbers is also challenging, because there is no single industry body or government agency that tracks failure rates. Arguably the most comprehensive assessments rely on data from the U.S. Small Business Administration (SBA), which provides loans to both franchise and non-franchise businesses. According to a 2014 *Wall Street Journal* analysis of SBA loans made between 2004 and 2013, franchisees who participated in franchise systems that had the highest overall default rates were unable to repay their loans more than twice as often as the average franchisee across all other concepts.⁸⁵ Other studies making use of this data come to conflicting conclusions as to whether franchise or non-franchise businesses are more likely to default on SBA loans.⁸⁶

From the perspective of a would-be entrepreneur who is considering the franchisee path, focusing on a specific franchise system is far more important than wondering about aggregate failure rates across concepts. Even then, past failure rates do not provide a complete picture, as franchise expert Robert Purvin explained to *Entrepreneur* in 2013:

Franchising is just a way of doing business; it's not a script for success. The world is constantly evolving, and all of those "proven" systems have to evolve, too. Proven success does not guarantee success tomorrow. Look at McDonald's: Thirty years ago it was focused on burgers and shakes; now it's a coffee shop. It has constantly innovated. Any company standing still and focused on its "proven method" is a company that will be a dinosaur. Buying a company that holds back from change is not a path to success.⁸⁷

Metrics

To some degree, franchisors help franchisee entrepreneurs determine the right metrics for the business. However, franchisors tend to care more about the percentage of revenue they generally receive as royalties, than the profits for franchisees. This means it is incumbent on franchisee entrepreneurs to think beyond what franchisors tell them. Usually, franchisee entrepreneurs end up measuring progress in terms of new customers, customer acquisition costs, labor costs, product costs, pricing per unit, and occupancy costs. They also consider metrics that offer a view of the overall health of the business: for example, revenue, EBITDA, free cash flow, and how those metrics are growing. Profitable growth is the goal for most franchisee entrepreneurs, for it ultimately drives return on investment. Franchisee entrepreneurs do not recklessly pursue growth for growth's sake alone. Market share is not the driving goal – profit is.

For Roberts, the most important operational metric is membership levels at her Pure Barre studios. Membership determines monthly revenue, which then flows through to monthly EBITDA. She rigorously manages personnel costs, because employee compensation is a major expense driver. Roberts has built her business over time organically and inorganically. In her mind, opening more locations, or acquiring existing ones that are underperforming, only makes sense if doing so provides desirable returns on invested capital.

Control (Rich vs. Royal)

Being a franchisee entrepreneur presents an interesting point on the rich versus royal spectrum. It is unlikely that franchisee entrepreneurs will accumulate billions, but there is a high probability of building considerable wealth over time. A portfolio of established, profitable franchises can generate annuity-like cash flows to provide a great life for the owner.

In general, franchisee entrepreneurs have a fair amount of control, for they answer to few, if any, external shareholders. The pace and location of expansion activities tend to be choices that the franchisee entrepreneur makes on her own. Of course, there is a limit to the franchisee entrepreneur's control, because the franchisor promulgates specific rules on how to run many aspects of the franchise operations. If a would-be entrepreneur bristles at the thought of complying with the franchise system's regulations, she would be wise to consider a different path.

For Roberts, becoming a franchisee entrepreneur struck the perfect balance on the control spectrum:

[Leaving finance to become a franchisee] was the best decision I've ever made. When you work for yourself, it's true that the buck stops with you and it [the business] never stops. However,

you get flexibility and independence. You get to pick your own priorities. You get the ability to create your own destiny, which is huge for me. In the corporate world, you usually can rely on other people to make sure things get done. But when you make the jump to entrepreneurship, there's no else to do them for you. Entrepreneurship really stretches your mind and forces you to learn new things. I love that challenge.

Day-to-day activities

Franchisee operators are deeply engaged in their businesses' daily management. Being a franchisee is an execution game, so operational precision matters a lot. In the early days, this means a franchisee will be wearing many hats. For example, Roberts was the first instructor at her original Pure Barre studio, and she continued teaching classes for a number of years, even when she was eight months pregnant with one of her children.

Over time, a balance develops between working in the business and on the business. People management consumes plenty of time. Purchasing and cost controls are important and demand daily attention. Franchisee entrepreneurs also must perform "big picture" tasks. Across franchise concepts these often involve assessing sites for new locations, lining up financing for expansion, and communicating with the franchisor on how to improve operations. That said, many strategic issues fall within the purview of the franchisor, who receives royalties, in part, to address them.

As Roberts's business has grown, she has stepped away from the inner workings of her studios. Once she opened her third Pure Barre location, she invested resources in building out mid-level management to provide close oversight of each location. This decision paid off handsomely, because her portfolio has more than doubled in size since then. She holds calls with each of her studio managers on a weekly basis, and she tries to visit the locations, which are now spread out across all of Massachusetts in suburban markets and Connecticut, as often as she can. And Roberts has assumed a number of responsibilities within the Pure Barre franchisee community.

Exit

Unlike tech and consumer branded products entrepreneurs, franchise entrepreneurs generally do not start with the goal of exiting a few years down the road. Rather, they tend to think about generating cash flow to support a lifestyle and personal economic needs over longer periods of time.

Still, there tend to be fairly good exit opportunities for franchisees, especially if they can achieve a scale of at least five to ten units. Periodically, franchise units trade within the franchise system, sometimes when the franchisee is struggling, but deals in which one franchisee tries to bulk up through acquisitions also happen. Additionally, private equity investors will purchase portfolios from franchisees, a trend which has increased in recent years.⁸⁸ For example, in May 2018, Atlantic Street Capital, a Connecticut-based private equity firm, acquired 14 Planet Fitness health clubs in Alabama and Virginia, a substantial addition to its existing portfolio of 15 locations in the Indianapolis metropolitan area. There are also some large multi-unit franchisees that are publicly traded companies, such as Carrols Restaurant Group (a Syracuse, New York-based owner and operator of more than 1,000 Burger King and Popeyes restaurants)⁸⁹ and Arcos Dorados (a Uruguayan firm that is the world's largest independent McDonald's franchisee).⁹⁰

Franchise assets tend to trade at reasonable multiples, typically in the 4.5 times to 8 times EBITDA range,⁹¹ for several reasons. Franchisees tend not to grow at astronomical rates, limiting the heights that transaction multiples can reach. Also, franchisors must approve franchisee acquirers, reducing the pool of potential buyers. In an interview with Axial, a network that connects buyers and advisors with middle-market companies looking to sell, Kevin Fretz, a franchise finance banker at BBVA Compass, noted that where sales multiples for franchisee assets fall on the valuation spectrum is highly influenced the rules set by franchisors:

[A]s a franchisee you are somewhat constrained as to what efficiencies can possibly be squeezed out of that operation from a cash flow margin perspective. You're ultimately bound by the limitations of the brand itself. Whereas, if you own the brand [i.e., you're the franchisor], I think your opportunity for growth and improvements in efficiencies is perceived as almost limitless, [which explains why EBITDA multiples for franchisors can vary from 6 times to 20 times].⁹²

Because of her academic training and financial industry experience, Roberts thinks about possible exits in a rational and disciplined way. Cash flows prevail as the value creation mechanism, but she knows that at some point she can choose to monetize the equity value of her business through a sale to an existing Pure Barre franchisee, an approved new operator, or a private equity firm.

Lifestyle

Being a franchisee entrepreneur often can support the millionaire next door lifestyle. Although she may never become a household name, she can do very well over time.

Flexibility is also important for many franchisees. This is certainly true of Roberts, who wants to be a highly engaged mother to her three young children:

Being a franchisee is still a lot of work, like other forms of entrepreneurship, but it's more flexible. You can set your own schedule and shift when you do the work as long as it gets done. I have three kids, and if something comes up with them, I can take time out for it, without having to ask anyone's permission. That's worth a lot to me.

For his part, Spongberg has lived a full life over the course of many decades as a franchisee. As of 2019, he has been married for 44 years, with six children and 14 grandchildren, and he has always been a consummate family man. A devout Mormon, Spongberg has long been active in his church, and has even held a number of leadership positions. Charity is also a big part of his life. He regularly volunteered to help the homeless in the Greater Los Angeles area for many years.

Intangibles:

MBA students typically do not pursue the franchisee form of entrepreneurship after earning their degrees. We believe there are two reasons that explain this phenomenon. The first is a lack of awareness. Franchisors generally do not recruit at business schools, and there is a dearth of case literature featuring franchisee success stories in MBA curricula. The second is an image problem. The

most visible franchise systems are fast food chains, which often have gained, rightly or wrongly, less than desirable reputations in the social circles where MBA students tend to find themselves. As the preceding sections have demonstrated, there is a lot more to franchise businesses than cheeseburgers, chicken nuggets, and chili fries – and there is absolutely nothing wrong with food service franchisees. MBA students would be well served exploring the many opportunities that exist for entrepreneurship in this area. As Roberts put it, “There’s a stigma that franchises are not cool, but there are actually a lot of interesting concepts out there. And more are popping up all the time.”

Identifying with the mission of a franchise is not as implausible as it might sound. In Roberts’ case, she fell in love with the quality and rigor of the Pure Barre exercise routine during her very first class in Wellesley, Massachusetts. She also believes strongly that each Pure Barre studio creates “a community of strong women,” and that as a franchisee, she is helping to foster a collective sense of purpose among her customers.

Risk

We believe that the franchisee form of entrepreneurship offers a moderate amount of risk. On the one hand, the work and inherent uncertainty involved with developing a business model are largely handled by the franchisor. Of course, not all franchisors are created equal. Some franchisors have established very strong business models and invested considerable sums in marketing, greatly reducing the franchise concept risk for the franchisee. A good example would be McDonald’s, a highly sophisticated franchisor that has refined the business model for its ubiquitous restaurants over decades. At the other end of the spectrum are new franchisors. These firms may ultimately succeed in scaling their nascent franchise concepts, but it is too early for a potential franchisee to know what will happen. Unfortunately, the history of the franchise industry is littered with failed concepts. The implication for a would-be entrepreneur is to understand the inherently higher risk involved with becoming a franchisee for an unproven franchisor, although the potential upside could be substantial if the concept proves to be a winning formula.

Arguably the three greatest risks for all franchisee entrepreneurs are execution risk, franchisor risk, and startup risk. Success for the franchisee depends in large part on the ability to execute the franchisor’s playbook, day in and day out. This is especially important when the franchise concept is proven. In that situation, a franchisee would be taking meaningful and unnecessary risk by deviating from the franchisor’s pre-scripted processes and procedures. The second major risk involves the franchisor. A franchisee pays upfront license fees and ongoing royalties, because she believes the franchisor has developed a solid concept, will invest in the brand, and act responsibly to grow the overall system. The problem is that not all franchisors live up to their end of the bargain. Underinvestment in brand building and systemwide overexpansion are franchisor-driven risks to the viability of any individual franchisee’s business. However, there is a mitigating factor to some degree. If the franchisor were to collapse, the franchisee would still own and operate her own units. If the units are, for example, hair waxing salons, the franchisee could simply change the name on her storefronts and continue running the underlying businesses, with the franchisor no longer in the picture. The third risk is startup risk. As was the case for VC-backed technology, cool branded consumer products, and “boring and basic” entrepreneurs, a franchisee is building her venture from scratch. There is no pre-existing “core” business that generates sufficient cash flow for the venture to be a going concern from Day One, and the associated risk is magnified by the high initial capital requirements for franchisee to pursue this path of entrepreneurship.

Entrepreneurship through Acquisition

Aspiring entrepreneurs often immediately think about starting a business from scratch to get in the arena. While we acknowledge that this is a typical perception of entrepreneurship, we highlight another form: where an entrepreneur acquires a small business with the goal of leading, operating, and building the business. This is often referred to as entrepreneurship through acquisition (as compared to entrepreneurship through startup). Although people have been purchasing existing businesses for centuries, Irv Grousbeck, MBA Class of 1980 Consulting Professor of Management at Stanford Graduate School of Business, is credited with conceiving and developing the entrepreneurship through acquisition process for MBA students in the 1980s. This is known as the “search fund” model.

The search fund approach has grown considerably over the last three and a half decades. According to a 2018 search fund study published by the Center for Entrepreneurial Studies at Stanford Graduate School of Business, investors poured \$924 million of equity capital into 325 search funds in the United States and Canada between 1984 and 2017. The asset class generated strong returns over that period, creating \$5.7 billion of equity value for investors and another \$1.5 billion for entrepreneurs.⁹³ Activity has accelerated in recent years, with nearly 150 search funds raised between 2014 and 2017.⁹⁴

Search funds are usually raised by freshly minted MBAs or by MBAs within a decade of their graduation. Their goal is to find a business to acquire and operate with the financial support of experienced investors, entrepreneurs, and business executives. Search fund entrepreneurs stand to earn a material equity position in the company by closing a deal, operating the business, growing enterprise value over time.

This twist on becoming an entrepreneur appeals to MBA students for several reasons. By acquiring an existing business, search fund entrepreneurs eliminate the need to come up with a groundbreaking or disintermediating idea that serves as the foundation for a venture. Additionally, buying a business that is already operating allows an entrepreneur to bypass the riskiest chapters of the entrepreneurial journey – the early innings when revenue and cash flow are scarce.

Search funds are a form of entrepreneurship, because they involve the pursuit of an opportunity beyond resources controlled. The search fund path requires a would-be entrepreneur to raise capital, find a company to acquire, structure and close a deal, and then grow the business well beyond its current size.

The search fund model has morphed and developed permutations in recent years. All of the different forms of search are oriented around buying a business, rather than starting a business. But within that context there are several different ways to structure a search fund.⁹⁵

Funded Search: An entrepreneur, or team of entrepreneurs, raise approximately \$300,000 to \$400,000 in search capital to attempt to find a business to acquire within a two- to three-year period. If the entrepreneur finds a business to acquire, investors have the right, but not the obligation, to invest equity in the acquisition of the target business. The search capital is typically stepped up into the acquisition by 50% (e.g., if the entrepreneur raised \$300,000 in search capital, that amount is rolled into the acquisition at 1.5x or \$450,000). The entrepreneur will run the acquired business as the CEO for 5 to 10 years and the investors will serve as board members. At some point, the business will likely be sold to a strategic or financial buyer. The entrepreneur has the opportunity to receive up to 25% to 30% of the equity based on closing the acquisition, subject to a vesting schedule and hurdle rates of return. She also typically earns a salary during the search and while as CEO.

Self-funded Search: An entrepreneur, or team of entrepreneurs, seek to purchase a business to run and operate. While searching for the target business, the entrepreneur uses her own capital for the search phase. If a target is identified, the entrepreneur might use her own capital to facilitate the acquisition or might raise outside capital in the form of common equity, preferred equity, or junior debt. The entrepreneur ends up owning somewhere between 30% to 100% of the equity. Having such a large stake allows the entrepreneur to determine if and when to pursue an exit. Typically, self-funded projects tend to be smaller in scale than funded projects due to capital constraints. In addition, the entrepreneur typically does not earn a salary during the search. However, as in other search fund models, the entrepreneur does earn a salary as CEO, provided the business generates enough cash to pay it.

Incubator Search: An incubated search typically involves a sponsor organization who assembles a cohort of highly talented searchers who have great potential as CEOs of small- to medium-sized businesses. The incubator trains them to efficiently search for suitable companies and effectively solicit potential sellers, bringing them up the learning curve in just 6 weeks rather than the 9 to 12 months it typically takes searchers on their own. The incubator helps them avoid wasting time on opportunities that won't work out by getting to "no" fast. While the searcher is responsible for negotiating and executing the deal, the incubator provides her with access to a team of diligence experts, lenders, lawyers, and experienced mentors, in case she needs help. The incubator then provides the equity financing required to complement the debt financing put in place by the searcher. Drawing on the strong personal relationship forged during the search phase, the incubator helps the searcher-turned-CEO select the right board of directors and navigate challenges in strategy, operations, sales, human resources, and other areas of the business. The entrepreneur typically winds up with a 25 percent carry (1/3 at close, 1/3 over four years, and 1/3 based on the returns achieved). Two percent of the carry is generally invested in a "common" fund that will give the search fund entrepreneur a piece of the incubator's other deals. As in the funded search model, the incubator-backed entrepreneur typically earns a salary during the search and while as CEO.

In the discussion that follows, we highlight the experiences of four recent Yale SOM graduates who have taken the search fund path. Their diverse personal backgrounds and professional experiences demonstrate that a wide range of individuals can successfully pursue entrepreneurship through acquisition.

Sumit Aneja (MBA 2014) bucked convention and did not raise a search fund immediately after graduating. Instead, Sumit went to Wall Street, where he worked for three years as an investment banker at Houlihan Lokey and Bank of America Merrill Lynch. This experience taught him the ins and outs of middle-market financing and deal structuring. It also allowed him to develop skills that complemented those he had gained earlier in his career as a researcher at the International Monetary Fund (IMF) and a systems engineer for Tata Consultancy Services (TCS). When he decided to pivot to raising a search fund in 2018, Sumit felt his varied career experiences and strong management education prepared him for the multi-faceted opportunities and challenges of purchasing and running a business. As a result, to him, the transition from investment banking to entrepreneurship was more evolutionary, than radical: "This is the culmination of so many professional and academic experiences in my life."⁹⁶ It took Sumit, armed with capital from about a dozen investors, roughly a year to find a company to buy. In early 2019, he acquired Voxco, a Montreal-based provider of both cloud-based and on-premise survey software.

Barriers to entry

Search funds do not have the same barriers to entry as other forms of entrepreneurship. Since a search fund is acquiring a going concern, the business exists and usually generates both revenues and profits. For search fund entrepreneurs, the main hurdle to overcome is raising capital in two stages: first, to conduct a search that can take up two years, and second, to finance the acquisition of the target company.

Aspiring entrepreneurs with certain educational backgrounds, professional experiences, and personal characteristics are well positioned to tap the ample pool of capital in the search fund asset class. Although there is no guarantee that all MBA students seeking to do a search fund can raise the search capital, many are able to secure funding for at least the initial search process. There are many individual investors and a handful of institutional investors (e.g., Relay Investments, Anacapa Partners, Pacific Lake Partners, Search Fund Partners) that specifically and serially back search fund entrepreneurs.

If the entrepreneur succeeds in identifying a business to purchase, the next barrier is raising equity and debt capital to fund an acquisition. Although the investors who financed the initial search are not required to participate in the proposed transaction, many end up doing so. After all, the investors will have had a two-year period to get to know the search entrepreneurs and evaluate their enthusiasm for backing the entrepreneur(s) in round two. However, even those investors who follow on will scrutinize the target business model, paying special attention to certain company attributes, such as contractually recurring revenues, customer attrition, EBITDA margins, organic growth opportunities, and capital intensity.

Another considerable hurdle along the search fund path is locating a desirable business to acquire. A target business must check several boxes. Not only does it need to have attractive economic fundamentals and the potential to scale, but it also must be the right size. And, of course, the seller has to be willing to do a deal at a reasonable valuation. Many search fund entrepreneurs stumble here. According to the 2018 Stanford search fund study, of the 325 search funds raised in the U.S. and Canada between 1984 and 2017, 233 were no longer searching, either because the principals failed to acquire a company or did purchase a company. Of those 233 search funds, only 160 (69 percent) ended up acquiring a company at all.⁹⁷

Persistence is key for search fund entrepreneurs, as the experience of Jose Moreno (MBA 2017) clearly demonstrates. Upon graduation, Jose returned to his native Colombia to search for a single business he would acquire and then operate for the long run. Evaluating acquisition targets came naturally to Jose, for he had worked as an investment banker and a private equity associate before enrolling at Yale SOM. Nevertheless, the right match eluded him for nearly two years, during which time he sourced and vetted more than 250 deal opportunities. Jose finally found what he was looking for in Azteca USP, a branded and private label food products company based about 10 miles southwest of Medellín. The firm already was a sizable business, with \$13 million in annual revenue and 220 employees, when the acquisition closed in March 2019. To Jose, now installed as CEO, Azteca USP provides a solid platform to “create long-term value for our customers, employees, and investors through multiple growth channels.”⁹⁸

For a very realistic assessment of the challenges in finding a “good” business to purchase, please see Benjamin Kessler’s fascinating article, “Search Funds: Death and the Afterlife.”⁹⁹

Key Differentiator

Differentiation in this form of entrepreneurship depends on the acquired business. If the search fund entrepreneur buys a company that competes on the basis of post-sale service, she will likely double-down on its existing advantage in this area. Ultimately, points of differentiation are levers for value creation over time, so the wise search fund entrepreneur will assess whether they are sustainable. She must not shy away from investing in new capabilities, especially if she doubts that established offerings, systems, and procedures will be sufficient to keep the company ahead of its rivals.

Path to going concern (product-market fit)

One of the most compelling aspects the entrepreneurship through acquisition model is that the new venture is a going concern on Day One. The company likely will have its faults, but its survival does not depend on a mad scramble to attract customers and generate cash flows. In fact, typically, a search fund entrepreneur will purchase a business that already produces \$1 million to \$3 million in EBITDA. We believe this “head start” greatly reduces the risk profile of search fund entrepreneurship, at least compared with launching either a technology or branded consumer product startup.

Another benefit is that the acquired business will have some existing systems and processes in place, no matter how rudimentary. This infrastructure will likely see further changes to become viable in the long run, but it gives the search fund entrepreneur time to get settled and learn the ins and outs of the business. Of course, she will be pulled in many different directions and have endless demands on her time when taking over the business, but she probably can manage through them without the existential concern of making payroll.

Metrics

Typically, a search fund entrepreneur receives financial backing a dozen or so sophisticated investors who have achieved success in other business ventures. These investors are willing to advise and mentor the freshly minted CEO, but their engagement is predicated upon earning a substantial return on their invested capital. The expected internal rate of return (IRR) generally falls somewhere between 25 percent and 35 percent. These expectations set a very high bar for search fund entrepreneurs to meet. As a result, search fund entrepreneurs usually view their daily activities through the lens of hitting that target. The metrics that will help them do that also deserve considerable amounts of attention and include revenue growth, return of initial investor capital, debt extinguishment, EBITDA margin expansion, and exit multiple expansion.

If a search fund asset has operating leverage, increased revenues will drive higher rates of growth in EBITDA. Generating free cash flow to extinguish debt or pay dividends to investors boosts returns and freezes the IRR clock. Ultimately, the main driver of returns will be the exit. Higher transaction multiples translate into more enterprise value and large IRRs.

According to the Stanford search fund study, the aggregate pretax IRR for search funds from 1984 through the end of 2017 was 33.7 percent, equating to an aggregate pretax return on investment (ROI) of 6.9 times on the equity capital invested.¹⁰⁰ Within the search fund universe, returns varied considerably, however. Excluding the three best-performing search funds from the analysis lowers the aggregate pretax IRR to 29.4 percent and the aggregate pretax ROI to 3.3 times. A snapshot of the

distribution illustrates the same point but in a different way. The median fund achieved breakeven (i.e., 0 percent IRR) for its investors, while the 75th percentile fund delivered a return of 2.9 times the initial capital invested (i.e., a 31 percent IRR).

Control (Rich vs. Royal)

Search fund entrepreneurs enjoy a high degree of control in their day-to-day activities – though not in all company affairs. Their investors and board members are not actively engaged in the operations of the business and want to keep it that way. However, investors and board members remain involved in strategic matters, such as raising money, contemplating an acquisition, approving a significant capital expenditure, and often the timing of an exit.

It is possible for successful search fund entrepreneurs to earn seven- to eight-figure paydays upon exit. In the meantime, they likely will enjoy salaries at or above post-MBA market rates. That said, they are unlikely to ever achieve the massive potential upside of VC-backed technology entrepreneurs.

Search fund entrepreneurs certainly do not enjoy complete control of their future and the business, and do not have the opportunity to create billion-dollar fortunes. However, they do strike a very compelling and interesting balance on the rich versus royal continuum. There is ample opportunity to create material wealth while enjoying significant control of one's own destiny.

Day-to-day activities

For search fund entrepreneurs, it can feel like next to impossible to get everything done during the day. There are human capital issues, customer issues, and operations issues, all with urgent needs. The key to figuring out how to best allocate time is a thorough understanding of the value drivers of the acquired business. Typically, the most value comes from a search fund entrepreneur working on the business, not working in the business. Working on the business involves building systems, establishing processes, implementing controls, and architecting the company's infrastructure. The purpose of these tasks is to create the conditions under which the business can continue to grow and/or become more profitable. On the other hand, when an entrepreneur is working in the business, her labor functions as one of the many inputs involved in the company's normal course of operations.

A search fund entrepreneur should be prepared to work at all levels of the organization. She needs to be as comfortable interacting with the CEO of a potential customer as she is addressing the concerns of one of her firm's hourly employees. Developing the ability to zoom in on the details and out to the bigger picture is critical for success.

Nevertheless, because the search fund model involves acquiring a business that is already a going concern, the entrepreneur, upon stepping into the CEO role, likely will have to spend less time than her startup counterparts on mundane tasks that do not add much to the long-term value creation process.

Exit

The primary goal of a search fund entrepreneur is to sell the acquired company in approximately four to eight years. That said, in some cases, the time horizon stretches to more than a decade, while in others,

the window may be as short as two or three years. Although a sale is almost always inevitable in this type of entrepreneurship, there are a few examples of search fund entrepreneurs who hold assets indefinitely and compensate their investors through dividends.

Exits are often driven by market opportunity through a formal auction sale process. If the business is sold to a financial acquirer, such as a private equity sponsor, the search fund entrepreneur might have to remain onboard for a while as the lead executive. However, if a strategic buyer purchases the company, then the search fund entrepreneur often gives up her leadership position as a condition of the transaction.

Lifestyle

A search fund entrepreneur enjoys a considerable amount of independence, but she is not alone on the journey. Her investors and board are usually happy to provide guidance and resources, without being overly intrusive.

That independence translates to flexibility. To be sure, the search fund path requires a lot of hard work, but the entrepreneur will typically have a fair amount of discretion over how, when, and where she chooses to work. For example, although travel is often part of the job for a search fund entrepreneur, she will not have anyone dictating to her when she must make the trip. Ultimately, investors and board members care much more about results than how they were achieved.

Control over schedule can be especially important for search fund entrepreneurs with families. One such individual is Judd Lorson (MBA 2017). By the time Lorson, a former submarine officer for the U.S. Navy, completed his MBA studies, he had been married for nearly a decade, and he and his wife expected to start a family soon. The couple moved from New Haven to Boston, where Lorson joined Search Fund Accelerator, an organization that partners with aspiring entrepreneurs who hope to acquire and run small to medium-sized businesses. The 18-month search was “hard work,” with “too many false starts and broken conversations to count,”¹⁰¹ and Lorson and his wife welcomed a baby boy into their family before the process was complete. In November 2018, months into the adventure of fatherhood, Lorson sealed a deal to purchase Alliance CAS, a Florida-based revenue management services provider. He relocated his young family to Fort Lauderdale in order to take the reins of the newly acquired company as CEO. “Absolutely thrilled and excited” at work and highly engaged at home, Lorson has since settled into a fulfilling life in South Florida.¹⁰²

Intangibles:

Search fund entrepreneurs often find a great deal of personal satisfaction in their work. They typically thrive on the responsibility and intellectual challenge. The opportunity for a young, recently minted MBA to become a CEO is exceedingly rare, and it is hard to put a number on what that opportunity is worth.

Entrepreneurship through acquisition can also allow young, ambitious businesspeople to make an impact on their communities. The experience of Kalil Diaz (MBA 2014), the first Yale SOM alumnus to raise a search fund, demonstrates that financial metrics need not be the only ones that matter in this form of entrepreneurship. When Diaz arrived in New Haven, he knew that he wanted to return to his native Dominican Republic after he earned his degree. At home he hoped to apply his entrepreneurial

drive to more than just interesting business problems. Doing well in the Dominican Republic would also mean doing good, for the country's citizens needed more private sector job opportunities. Diaz raised a search fund to acquire Contact Centers Dominicana, a nearshore operator of call centers, in 2017, and has created value for his investors as well as jobs for his fellow countrymen. In less than two years, revenue has jumped from \$4 million to nearly \$9 million, while headcount has tripled from 200 employees to 600. These new jobs, made possible by profitable growth, have "a real impact" on the community and serve as "a gateway to a middle-class life" for hundreds of families.¹⁰³

Another unique aspect of the search fund path is the network that comes along with being part of a tight-knit community of entrepreneurs. The common experience of identifying, acquiring, running, and exiting a business makes search fund entrepreneurs eager to help one another. Additionally, investors and board members can provide access to powerful networks, the value of which extends far beyond the initial search fund project. These can be lifelong, valuable resources that can be parleyed into future personal and professional opportunities

Risk

Overall, search fund entrepreneurship is a fascinating risk-adjusted way to enter into the entrepreneurial arena at fairly young age, typically the early thirties. On the one hand, the entrepreneur is reducing her risk by purchasing a going concern, instead of building a business from scratch. This, of course, assumes that the entrepreneur is able to raise a search fund, identify a target company, and close a deal to purchase. There is risk at each one of these stages. If the entrepreneur cannot consummate a transaction after an 18- to 24-month search, the outcome surely will be disappointing, but not disastrous. The reasons are two-fold. First, the entrepreneur generally collects a respectable salary during the search process, providing some measure of downside protection relative to other entrepreneurial paths, such as VC-backed technology and cool branded consumer goods startups, where cash compensation is often limited. Second, a two-year time investment for an entrepreneur with a strong academic pedigree in her early thirties does not foreclose other interesting career paths should the search fund not work out. In fact, the skills developed during the search fund process can be extremely valuable in other lines of work, including finance, consulting, operations, and sales.

Assuming that the search fund entrepreneur successfully acquires a business, there are two primary sources of risk. The first is execution risk. The cash flows generated by the target company's core business generally provide some degree of a safety, especially as the entrepreneur adjusts to managing an enterprise, usually for the first time. However, to create value for herself and her investors, she must execute whatever operational playbook she plans to employ. Usually, the search fund entrepreneur must drive both top-line growth and margin expansion, neither of which is a simple matter, even for an experienced executive. The entrepreneur's investors and Board members reduce this risk somewhat by standing ready to offer advice, but ultimately, she is still responsible for execution. Mentorship and guidance are not to be confused with hand-holding and running the business for the entrepreneur. The second main risk factor is financial leverage. In most cases, search fund entrepreneurs use a fair amount of debt to acquire the target business. Of course, this can magnify returns on upside, but it can similarly amplify financial and operational issues on the downside.

Family businesses, a genealogical takeover

Long-established family businesses provide yet another context for entrepreneurial activity. Of course, founding a family business is as entrepreneurial as launching any new venture, but often overlooked are instances when, either by choice or out of necessity, members of later generations assume leadership

positions within the enterprise. The changing of the generational guard often presents an opportunity for younger family members, often MBA students, to put their stamp on their own family business by reorganizing company structure, reassessing long-term strategy, and reimagining internal processes and procedures. Although the scope of reinvention can vary greatly, from incremental to comprehensive, we believe that the work involved and skills required to effect such changes are inherently entrepreneurial. As a result, we think MBA students with entrepreneurial ambitions and who come from families that own and operate their own businesses would be well served by exploring this path of entrepreneurship.

In assessing this opportunity, MBA students also should keep in mind that family-owned businesses have a large impact on the U.S. economy. Data compiled in 2018 by SCORE, a network of volunteer business mentors and experts, reveal that family-owned businesses generate 64 percent of U.S. gross domestic product (GDP), employ 60 percent of the U.S. workforce, and create 78 percent of all new jobs in the United States.¹⁰⁴ Family enterprises also represent 19 percent of the 28.8 million U.S. small businesses.¹⁰⁵

As more and more Baby Boomers, the generation born between 1946 and 1964, approach retirement age, many family businesses will need to effect a leadership transition in the not-too-distant future. This dynamic presents an interesting opening for would-be entrepreneurs in the next generation to take the reins and leave their mark. To be sure, situations will vary from family to family, but the overall opportunity is surprisingly large. In a recent survey of U.S. family business owners, 47 percent said they expected to retire in the next five years but had yet to draft a formal succession plan.¹⁰⁶

Klassen Business Group, a third-generation family business in Canada, is an instructive example of this form of entrepreneurship.¹⁰⁷ The company's roots stretch back to 1963, when Neil and Rita Klassen established Valley Pulp & Sawdust Carriers, a trucking company that hauled firewood and sawdust for nearby customers. In the early days, the firm had one truck and Neil made deliveries himself, often with his kids sitting by his side in the cab, while Rita kept the books and managed an office out of the family farm in Abbotsford, British Columbia, a city on the U.S.-Canada border about 45 miles southeast of Vancouver. The firm grew gradually over time under Neil and Rita's leadership, and four of their five children joined the business as teenagers. By the early 1990s, when the second generation took control of the operation, the firm had expanded its fleet to 12 trucks that carried logs, heavy equipment, and wood residuals for customers. Diversification into related lines of business, such as landscape supply, helped drive growth over the next decade and a half.

In 2008, the third generation, led by Travis Klassen and Erin Klassen-Parkes, cousins in their twenties, wanted to take on greater responsibility. A number of Neil and Rita's grandchildren had held part-time or full-time roles in the family for a while by then. With the second-generation approaching retirement age, it was clear that succession planning had to start sooner rather than later. Travis organized a family meeting that included all three generations. The grandchildren peppered their parents and grandparents with questions about the business. Some answers were forthcoming, but others were not. It became clear to all in attendance that the third generation was ready for larger roles and that the largely informal family business had to be professionalized if it was to survive for the long run. As Travis recalled in an interview with *Family Business Magazine*:

You grow up fairly naïve and assume the company must be doing well and there must be millions of dollars in the bank. Then you open the bank, and you realize that if this is going to sustain all of us for the rest of our lives, we need to make some big changes very quickly. We had to come up with a plan. We could either grow the company or we would bleed it dry.¹⁰⁸

Barriers to entry

There are two main barriers to entry in this form of entrepreneurship. First, the would-be entrepreneur typically must be a member of a family that has a family business for her to take over. Although there are some cases where a non-family member assumes the CEO role at a privately owned family business, this generally does not happen. Second, the older generation may not be ready and willing to hand the reins to the younger one. Successfully navigating this dynamic requires that the aspiring entrepreneur to have patience, humility, empathy, and tact.

Key differentiator

What differentiates a family business will depend in large part on the industry in which it operates. That said, when an entrepreneur assumes control through a genealogical takeover, she has a unique opportunity to put her stamp on the business.

Improving the organizational structure of the family business was a key priority for the third-generation Klassens. Travis and Erin recognized that the family needed outside help, so they retained the services of a variety of tax and legal advisors. A multi-year effort resulted in a new holding company structure that protected the family's economic interests, facilitated the efficient transfer of ownership stakes from one generation to the next, improved the managerial oversight of core operations, and created – for the first time in the family business's history – formal board-level corporate governance.

Under the new model, all major business lines became distinct subsidiaries of Klassen Business Group. The main trucking business, Valley Carriers, generated about 70 percent of Klassen Business Group's \$23 million of revenue in 2017. Since 2014, Travis has served as CEO of Klassen Business Group and COO of Valley Carriers, while Erin holds the position of CFO for both entities.

Path to going concern (product-market fit)

A genealogical takeover usually involves a family business that is already a going concern. However, with a fresh perspective, the entrepreneur will have a chance to fix anything that is broken and chart a course for the company's long-term success.

Upon taking over after a few tough years for the family business in the early 2010s, third-generation leadership drove growth in a manner that Travis described as “honoring the foundation and embracing the future.” For starters, the company built from scratch a new operating hub in Merritt, British Columbia, roughly 125 miles northeast of the headquarters in Abbotsford. This expansion, which involved nearly 20 trucks and almost 40 employees, allowed Valley Carriers and other divisions to serve customers in a larger geographic area. The younger generation also redesigned the fleet management practices to reduce upfront capital expenditures and save on maintenance costs over time. A third growth vector was the establishment of new business lines, most notably Klassen Wood Co., a packager and distributor of wood shavings that brought in \$5.5 million in revenues in 2017. Finally, Travis and Erin have used M&A to grow the business and consolidate a relatively fragmented industry.

The Klassen family has reaped considerable fruits from the leadership and vision of the third generation. Consolidated revenues of \$23 million in 2017 easily exceeded Travis's target to reach \$20 million by 2020. Valley Carriers was named as one of PROFIT 500's fastest-growing Canadian companies in 2017 and 2018 on a trailing five-year basis. The fleet has swelled to about 50 trucks that serve customers in British Columbia, Alberta, and Washington state. Headcount now exceeds 100 employees, about a quarter of whom are family members in full-time or part-time positions.

Metrics

Measures of success will vary from one family business to another. However, since the primary goal of most family businesses usually is to provide employment opportunities and financial security for future generations, entrepreneurs of this sort tend to focus on achieving steady profits and cash flows year after year.

Qualitative objectives tend to be important in this arena as well. Building, or at least maintaining, the family's reputation and status in the community is often a critical success factor. Achieving harmony between different members, or different parts, of the family is another common goal.

Employment opportunities for family members can be measured both quantitatively and qualitatively. Of course, the number of jobs held by, or available to, family members is the simplest metric, but the level of compensation, relative to alternative opportunities, that the family business can support for family members in various roles is also important. On the qualitative side, there is clear but intangible value to knowing that the family business can provide employment for family members if the situation requires. The same can be said for the ability to create pathways of advancement for family members within the business over time.

Control (Rich vs. Royal)

A genealogical takeover of a family business generally offers a balance on the "rich and royal" spectrum. Although a few family businesses, such as Koch Industries and Bechtel Corporation, are capable of producing huge amounts of wealth, many more support a comfortable, but not extravagant, standard of living for family members across multiple generations. Typically, families exercise large amounts of control over their enterprise, because they rely on little, if any, external capital to finance the operations. That said, power and influence are often shared among family members, and important decisions are made by consensus.

Day-to-day activities

An entrepreneur who takes over a family business will work hard, but probably will not face the same demands as her counterparts elsewhere in the world of entrepreneurship. Nevertheless, in addition to running a company, the entrepreneur may find she has to spend a fair amount of time managing relationships with family members. The nature of these interactions will depend on many factors, including the specific family member's personality, age, experience level, and role within the business.

Exit

This form of entrepreneurship has the least potential for exit among the ones we examine here. The reason is simple: Most families want the business to remain in the family for years, if not generations, to come. Dividend payments and bank refinancings are the primary ways to tap equity value that builds up in a family business over time.

Lifestyle

A family business entrepreneur likely will enjoy an attractive work/life balance for two reasons. First, the core operations of the family business typically will provide a solid foundation, so the entrepreneur will not have to scramble frantically just to keep the company going. Second, the investors are other family members, not general partners at institutional venture capital firms.

Arguably the most important factor for a would-be entrepreneur to consider is whether she wants to navigate the family dynamics that come with the family business. Sometimes, running a family business will mean problems at work will follow the entrepreneur home, and vice versa.

Intangibles

The main intangible here is working with one's family members. This can be a very rewarding proposition. There is also a distinct pride that comes with continuing a family legacy and providing for future generations. Finally, since the family controls the business, the family can decide whether to use it as a vehicle to accomplish non-financial objectives.

In 2012, the third generation of the Klassen family established the Klassen Foundation. This move institutionalized the family's long-standing philanthropic efforts and, through better coordination and organization, increased the charitable impact the Klassen family could make. Of particular importance was preserving the ability to contribute consistently to the causes and organizations that the family believed in, regardless of Klassen Business Group's financial performance in any given year.

Risk

We believe that a genealogical takeover of a family business is a relatively low risk form of entrepreneurship, because there is little, if any, business model risk. After all, the family business is already a going concern.

Of course, there may still be risks in this entrepreneurial pathway. For starters, execution risk remains, and it arguably increases with the scope of reforms that the new generation of leadership tries to make. Simply put, the more changes that are made, the more opportunity for missteps. Nevertheless, the fact that the family business is already a going concern somewhat mitigates the downside. The existing foundation likely will enable the entrepreneur to course-correct if new strategies, processes, and/or systems do not work out as anticipated. To be sure, this is a luxury, or safety net, that entrepreneurs who follow different paths often do not enjoy.

Perhaps the most unique form of risk associated with this pattern of entrepreneurship is the dynamics within the family – especially if things go wrong. Since, generally speaking, many family members depend on the viability of the family business, the entrepreneur will likely have to answer to stakeholders at different stages in their lives, with varying levels of business experience, and with demands motivated by sometimes conflicting agendas. Adding the emotional complexities of family relationships on top of all that makes resolving any disputes that may arise a delicate balancing act, and it is probable that the entrepreneur will not be able to satisfy everyone.

Conclusion

We hope that after reading this note, MBA students will have a better understanding of, and appreciation for, the wide range of entrepreneurial opportunities that exist. Regardless of the specific path they choose to take, we believe that they will find entrepreneurship is a rewarding and fulfilling career choice. We remind each student, as we advised at the outset of this note, that the key is to choose the entrepreneurial path that best fits her professional interests, personal values, desired lifestyle, and risk appetite – not what seems, at first blush, to be the most glamorous or popular option.

We do not seek to persuade readers that one form of entrepreneurship is “better” than any other, for a freshly minted MBA can achieve wealth and happiness along any of the paths outlined here, as well as

countless others that are beyond the scope of this article. Rather, we encourage our readers to answer for themselves, as honestly as possible, the two questions we posed in the introduction:

- 1) which form of entrepreneurship has the highest probability of success, however you define it?
- 2) which one will best accommodate the lifestyle you envision for yourself?

To assist in this self-assessment process, we provide, in **Exhibit 1**, a summary of the six patterns outlined here. Then, informed by their reflections, students can thoughtfully validate, or recalibrate as needed, the screening criteria they are using to search for their next entrepreneurial venture.

Good luck!

This case has been developed for pedagogical purposes. The case is not intended to furnish primary data, serve as an endorsement of the organization in question, or illustrate either effective or ineffective management techniques or strategies. Dollar amounts have been disguised for proprietary reasons.

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Exhibit 1: Summary of Six Patterns of Entrepreneurship

Criteria	VC-Backed Technology	Cool Consumer Products	Boring and Basic	Franchisee	ETA / Search Fund	Family Business Takeover
Example	Slack Technologies	Smitten Ice Cream	Tradewind Aviation	Liz Roberts / Pure Barre	4 Recent Yale SOM Alums	Klassen Family
Source of Capital	Venture Capital	Venture Capital	Friends & Family; Debt	Friends & Family; Debt	Small Investors	Family & Debt
Exit	IPO	IPO/Sale	Strategic	Strategic/PE	Strategic/PE	Strategic
\$ Potential	Very High (9-10 figures)	High (8-10 figures)	Medium (8-9 figures)	Moderate (7-8 figures)	Medium (7-8 figures)	Medium (7-8 figures)
Control	Low	Low	High	High	High	Medium / High
Risk	High	High	Medium	Medium	Medium	Low
Image and Status	California cool	Trendy and hip	Workmanlike	Burgers & Donuts	Low visibility	Prince of the city
Work/Life Balance	Low	Low	High	High	Medium	High
Coach kids' soccer	No way	No way	1 team	1 team	Not at first	2 teams
Mode of Transportation	Uber	Bird scooter	Subaru	Lexus	B school car	Mercedes
Illustrative Location	San Francisco	Brooklyn	Pittsburgh	Dallas	Orlando	Minneapolis

Source: Authors' analysis.

Endnotes

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