

Getting Personal *with* PHONE HALO



Cofounders:

CHRIS HERBERT

BS, College of Engineering,
University of California, Santa Barbara,
spring 2007

CHRISTIAN SMITH

BS, College of Engineering,
University of California, Santa Barbara,
spring 2007

Dialogue *with* **Chris Herbert**

CURRENTLY IN MY SMARTPHONE

A State of Trance with Armin van
Buuren

MY ADVICE FOR NEW ENTREPRENEURS

Make sure your team can build and
ship the product without outside
investment.

WHAT I DO WHEN I'M NOT WORKING

Surfing, kitesurfing, studying
Japanese, and hanging out with
friends

FIRST ENTREPRENEURIAL EXPERIENCE

Building a haunted house

MY BIGGEST SURPRISE AS AN ENTREPRENEUR

If you're on the brink of failure,
you're also on the brink of success.

BEST ADVICE I'VE RECEIVED

Know what you don't know.

CHAPTER 14

Strategies for *Firm Growth*

OPENING PROFILE

PHONE HALO

Pivoting to Pursue New Strategies for Growth

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In 2008, Chris Herbert wanted to enter the business plan competition at the University of California, Santa Barbara (UCSB). He and several friends were brainstorming business ideas in the Carrillo Dining Commons and were about to give up when a friend walked in, dejected because he had lost his mobile phone. Herbert thought, "That's it. Let's develop a device that prevents people from losing their mobile phones."

Herbert partnered with two friends, Christian Smith and Tyler Crain, to flesh out the idea. All three were engineering students at UCSB. They entered their preliminary idea, of a bi-directional keychain sensor that sends an alert when you've moved a certain distance from your mobile phone, into their college's business plan competition. They lost. Undeterred, the three continued to work on the idea. The following year they entered the same competition, which is hosted by UCSB's College of Engineering, and took first place. All three team members graduated in May 2009, and rejected job offers to work on the idea full time, which is now named Phone Halo. They literally worked out of a garage in downtown Santa Barbara, building the initial prototype of their device. To develop the Phone Halo system, the three founders had to learn on the fly in regard to the technical aspects of building an iPhone app and a hardware device that would communicate seamlessly with each other. Herbert's training was in optical fibers, but he refocused on Bluetooth and the wireless elements of the Phone Halo system. Crain's training was in computer algorithms, and he refocused on software and application development. Smith's training was in manufacturing engineering, and he refocused on industrial design.

The first full prototype of the Phone Halo system was ready in October 2009. The three founders took Phone Halo to the International Consumer Electronics Show in January 2010, and received a big boost. Their app and device were written up in the *Wall Street Journal* and in several blogs. The thing that intrigued the

LEARNING OBJECTIVES

After studying this chapter you should be ready to:

1. Explain the difference between internal growth strategies and external growth strategies.
2. Identify the keys to effective new product development.
3. Explain the common reasons new products fail.
4. Discuss a market penetration strategy.
5. Explain what an "international new venture" is and describe its importance to entrepreneurial ventures.
6. Discuss the objectives a company can achieve by acquiring another business.
7. Identify a promising acquisition candidate's characteristics.
8. Explain "licensing" and how it can be used as a growth strategy.
9. Explain "strategic alliances" and describe the difference between technological alliances and marketing alliances.
10. Explain "joint ventures" and describe the difference between a scale joint venture and a link joint venture.

press and the bloggers the most is how the system works. The app is available through the BlackBerry and Android online markets, and the hardware device is available at Amazon.com. Once the app is downloaded, it uses Bluetooth to wirelessly connect to the Phone Halo hardware device. The device can be attached to anything—your keychain, wallet, purse, or even to your wrist. If you're carrying the device and it gets about 30 feet from your phone, both the device and your phone will make a sound, to alert you that they've been separated. Your phone will then text you its GPS coordinates allowing you to find it if following the sound doesn't work. You can even have your phone's GPS coordinates e-mailed to your friends or posted on one of your social networking sites. The app is free and the hardware device costs about \$60.

Phone Halo received another boost when the cofounders presented their product at Demo Spring 2011. Demo is a technology conference that focuses on showcasing new products from both start-ups and established companies. The Phone Halo system was a hit, and even won one of the conference's prestigious awards. It also won the *Popular Mechanics* Editor's Choice Award in 2011. In the photo, Hubert is on the left and Smith is on the right, holding memorabilia acknowledging the award.

Although Phone Halo's cofounders were buoyed by the publicity they generated at the 2010 International Consumer Electronics Show and Demo Spring 2010, 2010 was a tough year for the company. One of the three cofounders, Tyler Crain, left the company to take a fellowship in France. That was a blow because Crain was Phone Halo's main software engineer. Jacques Habra, a businessperson the Phone Halo team met the second year they entered the UCSB business plan competition, had been helping with business development but was moving on. The funding environment was also tough. It was particularly difficult to get Phone Halo's hardware device into big-box stores, like Best Buy, where they'd have visibility and shelf space. Big-box stores are very demanding in terms of the requirements they place on suppliers. For example, to have its product in Best Buy, Phone Halo would have to maintain inventory and build out its own supply chain, so it could deliver product to Best Buy in an expedient manner. Phone Halo didn't have the financial resources to go this route.

In late 2010, Phone Halo, now led by Herbert and Smith, pivoted and adopted a licensing model to move the firm forward. Instead of producing the Phone Halo mobile phone app and hardware device themselves, they would license their technology to third parties. Right out of the gates, they landed a licensing deal with Cobra Electronics, a leading manufacturer of electronics products. Cobra is now producing the Cobra Phone Tag, a Bluetooth-enabled tracking system for mobile phones and other valuables, powered by Phone Halo's technology. In early 2011, *Popular Mechanics* awarded Cobra Electronics one of its Editor's Choice Awards for the Cobra Phone Tag. Phone Halo is now seeking additional licensing opportunities to accelerate its growth.¹

Phone Halo's experience is not unusual. While many young entrepreneurial firms are able to build on their initial strategy for growth, others, like Phone Halo, pivot when their initial strategy isn't working and pursue one or more new avenues for growth. In this chapter, we discuss the most common strategies firms use to grow. The growth strategies are divided into internal strategies for growth and external strategies for growth, as shown in Figure 14.1.

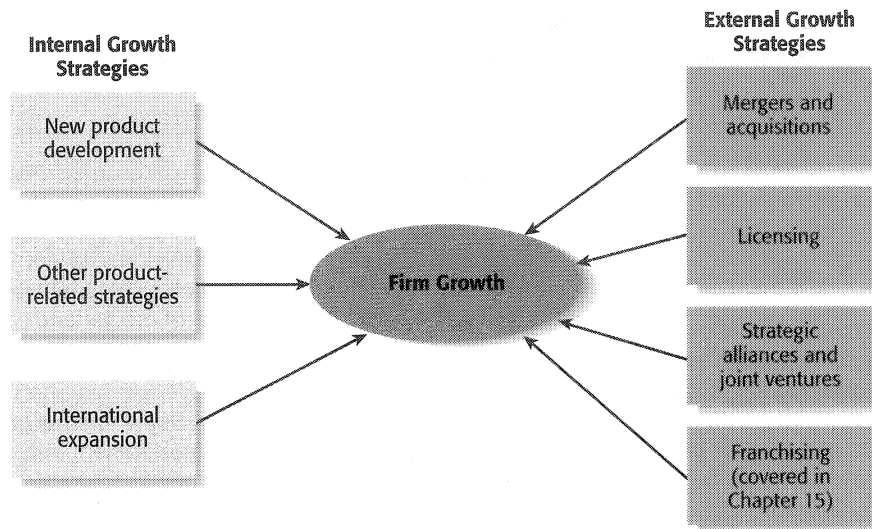


FIGURE 14.1
Internal and External
Growth Strategies

INTERNAL GROWTH STRATEGIES

Internal growth strategies involve efforts taken within the firm itself, such as new product development, other product-related strategies, and international expansion, with the purpose of increasing sales revenue and profitability. Many businesses, such as ModCloth, Zipcar, and Zappos, are growing through internal growth strategies. The distinctive attribute of internally generated growth is that a business relies on its own competencies, expertise, business practices, and employees. Internally generated growth is often called **organic growth** because it does not rely on outside intervention. Almost all companies grow organically during the early stages of their organizational life cycles.

Effective though it can be, there are limits to internal growth. As a company enters the middle and later stages of its life cycle, sustaining growth strictly through internal means becomes more challenging. Because of this, the fear is that a company will “hit the wall” in terms of growth and will experience flat or even declining sales. This can happen when a company has the same product or service that it’s trying to sell to the same list of potential buyers. Companies in this predicament need to either expand their client list, add new products or services to complement their existing ones, or find new avenues to growth. Sometimes companies face this challenge through no fault of their own. For example in 2009 Wing Zone, a restaurant franchise, was experiencing flat sales in that prospective franchisees couldn’t get financing because of the credit crunch. To work around this challenge, the company decided to expand internationally. In November 2010 it opened its first international franchise in Panama City, Panama. Several other franchise organizations, including Massage Heights, Molly Maids, and fire and water cleanup companies PuroClean and Servpro, have recently expanded internationally for the same reason.²

Some start-ups, to avoid quickly hitting the wall in terms of growth, configure their initial products or services in ways that have built in growth potential. This tactic is illustrated in the “Savvy Entrepreneurial Firm” feature shown on p. 465. SwitchFlops is an example of a company that has “built-in” avenues for future growth as a result of the unique nature of its product and how it’s configured.

We list the distinct advantages and disadvantages of internal growth strategies in Table 14.1.

LEARNING OBJECTIVE

1. Explain the difference between internal growth strategies and external growth strategies.

TABLE 14.1 ADVANTAGES AND DISADVANTAGES OF INTERNAL GROWTH STRATEGIES

Advantages	Disadvantages
<p>Incremental, even-paced growth. A firm that grows at an even pace can continually adjust to changing environmental conditions to fine-tune its strategies over time. In contrast, a firm that doubles its size overnight through a merger or acquisition is making a much larger commitment at a single point in time.</p> <p>Provides maximum control. Internal growth strategies allow a firm to maintain control over the quality of its products and services during the growth process. In contrast, firms that grow through collaborative forms of growth, such as alliances or joint ventures, must share the oversight function with their business partners.</p> <p>Preserves organizational culture. Firms emphasizing internal growth are not required to blend their organizational culture with another organization. As a result, the venture can grow under the auspices of a clearly understood, unified corporate culture.</p> <p>Encourages internal entrepreneurship. Firms that grow via internal growth strategies are looking for new ideas from within the business rather than from outside stakeholders. This approach encourages a climate of internal entrepreneurship and innovation.</p> <p>Allows firms to promote from within. Firms emphasizing internal growth strategies have the advantage of being able to promote within their own organizations. The availability of promotional opportunities within a firm is a powerful tool for employee motivation.</p>	<p>Slow form of growth. In some industries, an incremental, even-paced approach toward growth does not permit a firm to develop competitive economies of scale fast enough. In addition, in some industries, it may not be possible for a firm to develop sufficient resources to remain competitive. A high level of merger and acquisition activity typically characterizes these industries.</p> <p>Need to develop new resources. Some internal growth strategies, such as new product development, require a firm to be innovative and develop new resources. While internal innovation has many positive attributes, it is typically a slow, expensive, and risky strategy.</p> <p>Investment in a failed internal effort can be difficult to recoup. Internal growth strategies, such as new product development, run the risk that a new product or service idea may not sell, making it difficult to recoup the development cost the firm incurred.</p> <p>Adds to industry capacity. Some internal growth strategies add to industry capacity, and this can ultimately help force industry profitability down. For example, a restaurant chain that grows through geographic expansion may ultimately force industry profitability down by continuing to open new restaurants in an already crowded market.</p>

New Product Development

LEARNING OBJECTIVE

2. Identify the keys to effective new product development.

New product development involves designing, producing, and selling new products (or services) as a means of increasing firm revenues and profitability. In many fast-paced industries, new product development is a competitive necessity. For example, the average product life cycle in the computer software industry is 14 to 16 months, at the most. Just thinking of how quickly we are introduced to new computers, new iPads, and related products quickly highlights for us how rapidly products change in this industry! Because of these rapid changes, to remain competitive, software companies must always have new products in their pipelines. For some companies, continually developing new products is the essence of their existence.

Although developing new products can result in substantial rewards, it is a high-risk strategy. The key is developing innovative new products that aren't simply "me-too" products that are entering already crowded markets. When properly executed though, there is tremendous upside potential to developing new products and/or services. Many biotech and pharmaceutical companies, for example, have developed products that not only improve the quality of life for their customers but also provide reliable revenue streams. In many cases, the products are patented, meaning that no one else can make them, at least until the patents expire. Successful new products can also provide sufficient cash flow to fund a company's operations and provide resources to support developing additional new products. For example, Amgen, a large and historically profitable biotech company, has two stellar pharmaceutical products,

SAVVY ENTREPRENEURIAL FIRM

SwitchFlops: How to Create Built-In Avenues for Future Growth

Web: www.lindsay-phillips.com

Twitter: *SwitchFlops*

Facebook: *SwitchFlops*

One thing that savvy growth-minded start-ups do is configure their products or services in ways that have built-in growth potential. Producing “one-off” products or services leads to limited growth potential. Instead, it’s best to produce products and services that if successful provide natural segues to complementary products and services that can be added later.

SwitchFlops are sandals with interchangeable straps. Lindsay Phillips developed the original idea for these products when enrolled in high school, as part of an art project when she was 16. Amazed by the response, Phillips continued with the project. She started designing functional flops with colorful straps, each adorned by a unique button. She realized that by using a hook and loop fastener on each flop, she could create a shoe that accommodated interchangeable straps. This was the birth of SwitchFlops. A shopper buys one pair of SwitchFlops sandals, and can then purchase interchangeable straps.

During her college years, Phillips fine-tuned her design, merchandising, and manufacturing skills working summers at Polo Ralph Lauren’s leather goods division in New York City. She also traveled to Europe for classes and enrolled in the Semester at Sea program. These later two experiences exposed her to a variety of colors, cultures, and patterns that helped her fashion unique strap designs. A patent on her unique approach was granted in 2004. SwitchFlops made its retail debut in January 2007 at the Surf Expo Trade Show in Orlando, Florida, where it was showcased as a new, creative product.

SwitchFlops started with several basic sandal designs and 10 straps. Most customers bought more than one pair of sandals and several straps allowing them to “customize” their look by trading out sandals and straps. Most customers seemed to enjoy this experience. SwitchFlops’ value proposition was both versatility and value.

Today, SwitchFlops sandals cost \$49 and the straps cost between \$12 and \$15 each. To make it fun, the sandals and straps all have names. Sandals include Lilly, Missy Wedge Heel, and Emma. Straps include Annan

Strap, Rowan, Mary Lee, and Casey Strap. There are now multiple SwitchFlops sandals and straps to choose from. Today, SwitchFlops sandals and straps are sold in more than 4,000 stores around the world. Phillips has evolved her footwear line and currently sells ballet flats, wedges, and espadrilles along with sandals and has added shopping bags, scarves, and sandals for children to her firm’s product lines.

SwitchFlops sandals benefit from being both fashion-conscious and economical. Instead of owning 10 pairs of sandals, a customer can own two or three, and have multiple “looks” by changing out straps. By making a product (sandals) that is based on buying add-ons (straps), the strategy has also benefited SwitchFlops and helped fuel its growth.

Questions for Critical Thinking

1. As an up-and-coming entrepreneur, what things did Lindsay Phillips do to equip herself to lead a growth-oriented firm?
2. Think of a company that sells a product or service that’s similar to SwitchFlops, in that the product or service provides a natural segue to add-on products or services. Briefly explain the product and its built-in avenues for future growth.
3. Of the companies featured in the “You Be the VC” features in the book, which company has a product or service that is best positioned for natural segues for future growth? Explain your answer.
4. Why do you think SwitchFlops has been so successful? Draw lessons from several chapters of the book to formulate your answer.

Sources: Lindsay Phillips Web site, www.lindsay-phillips.com (accessed April 14, 2011); Business Pundit Blog, “SwitchFlops: A Smart, Successful Fashion Startup,” www.businesspundit.com/switchflops-a-smart-successful-fashion-startup (accessed April 13, 2011, originally posted on September 8, 2010).

Enbrel and Neupogen. Enbrel is a tumor necrosis factor (TNF) blocker that is used to treat rheumatoid arthritis as well as some related conditions, and Neupogen helps prevent infection in cancer patients undergoing certain types of chemotherapy. These products have provided the company sufficient revenue to cover its overhead, fund new product development, and generate profits for an extended period of time.³

The keys to effective new product and service development, which are consistent with the material on opportunity recognition (Chapter 2) and feasibility analysis (Chapter 3), follow:

- **Find a need and fill it:** Most successful new products fill a need that is presently unfilled. “Saturated” markets should be avoided. For example, in the United States as well as in most developed countries, consumers have a more-than-adequate selection of appliances, tires, credit cards, and cell phone plans. These are crowded markets with low profit margins. The challenge for entrepreneurs is to find unfilled needs in attractive markets and then find a way to fill those needs.
- **Develop products that add value:** In addition to finding a need and filling it, the most successful products are those that “add value” for customers in some meaningful way.
- **Get quality and pricing right:** Every product represents a balance between quality and pricing. If the quality of a product and its price are not compatible, the product may fail and have little chance for recovery. To put this in slightly different terms, customers are willing to pay higher prices for higher-quality products and are willing to accept lower quality when they pay lower prices.
- **Focus on a specific target market:** Every new product and service should have a specific target market in mind, as we have highlighted throughout this book. This degree of specificity gives the innovating entrepreneurial venture the opportunity to conduct a focused promotional campaign and select the appropriate distributors. The notion that “it’s a good product, so somebody will buy it” is a naïve way to do business and often contributes to failure.
- **Conduct ongoing feasibility analysis:** Once a product or service is launched, the feasibility analysis and marketing research should not end. The initial market response should be tested in focus groups and surveys, and incremental adjustments should be made when appropriate.

LEARNING OBJECTIVE

3. Explain the common reasons new products fail.

There is also a common set of reasons that new products fail, as articulated by EcoStrategy Group and shown in Table 14.2.⁴ It behooves entrepreneurs to be aware of these reasons and to work hard to prevent new product failures as a result of poor execution in these areas.

TABLE 14.2 THE TOP 10 REASONS NEW PRODUCTS FAIL

1. Target market is not defined correctly.
2. Product is not positioned effectively.
3. Product’s benefits are not understood by the target customer.
4. Product doesn’t address important customer needs.
5. Product is seen as incomplete, or it requires too many ancillary services or other prerequisites.
6. Product costs too much or the total cost of ownership is out of line with perceived benefits.
7. Sales and marketing efforts are not focused and aligned.
8. Sales cycles are longer than expected.
9. The company is under-investing in marketing and sales efforts.
10. The target market is smaller than originally projected or the product is too far ahead of the market.

This discussion is a reminder that achieving healthy growth, whether via the development of new products or another means, a firm must sell a product or service that legitimately creates value and has the potential to generate profits along with sales.

Other Product-Related Strategies

Along with developing new products, firms grow by improving existing products or services, increasing the market penetration of an existing product or service, or pursuing a product extension strategy.

Improving an Existing Product or Service A business can often increase its revenue by **improving an existing product or service**—enhancing quality, making it larger or smaller, making it more convenient to use, improving its durability, or making it more up-to-date. Improving an item means increasing its value and price potential from the customer's perspective. For example, software firms routinely increase revenues by coming out with “updated” versions of an existing software product.

A mistake many businesses make is not remaining vigilant enough regarding opportunities to improve existing products and services. It is typically much less expensive for a firm to modify an existing product or service and extend its life than to develop a new product or service from scratch. For example, many women have set aside the flat irons that they've used for years to do their hair and have bought a ceramic flat iron because they're safer and do a better job. Selling “improved” flat irons is a much less expensive way for curling iron manufacturers to grow sales than to develop a completely new product.

Increasing the Market Penetration of an Existing Product or Service A **market penetration strategy** involves actions taken to increase the sales of a product or service through greater marketing efforts or through increased production capacity and efficiency. An increase in a product's market share is typically accomplished by increasing advertising expenditures, offering sales promotions, lowering the price, increasing the size of the sales force, or increasing a company's social media efforts. Consider Proactiv, the skin-care company that is the focus of Case 11.2. Since its inception in 1994, Proactiv has relied on celebrity endorsers to demonstrate and promote its product. Judith Light and Vanessa Williams were the firm's first celebrity endorsers. Over the years, the company has added additional celebrity endorsers, including Anthony Robbins, Jessica Simpson, and Jane Seymour to appeal to a broader and more diverse clientele. Avril Lavigne, Katy Perry, Julianne Hough, Jenna Fischer, and Justin Bieber are celebrities recently added to Proactiv's list of well-known endorsers of the firm's products. Adding Justin Bieber exposes Proactiv to a new market—teenage boys. Dr. Katie Rodan, a cofounder of Proactiv, points to the celebrity endorser program as one of the savviest actions the company has taken to build market share.⁵

Another example is the prepaid card, like the Starbucks Card, that almost all restaurants and retailers now offer. By making it more convenient for customers to purchase its products, restaurants and retailers boost their revenues. Prepaid cards also make it easier to give a restaurant's or retailer's offering as a gift. Think of how many people buy Target, Macy's, or Pottery Barn prepaid (gift) cards as birthday or holiday gifts. A benefit to those receiving these cards is the opportunity to use them to buy a product that fulfills a true need.

Increased market penetration can also occur through increased capacity or efficiency, which permits a firm to have a greater volume of product or service

LEARNING OBJECTIVE

4. Discuss a market penetration strategy.

Proactiv is a one product company that has grown by increasing its market penetration over time. Proactiv just added Justin Bieber as a celebrity endorser in an attempt to open a new market for its product—teenage boys. Here, Bieber is holding a bottle of Proactiv acne treatment.



Proactiv/Splash News/Newscom

to sell. In a manufacturing context, an increase in product capacity can occur by expanding plant and equipment or by outsourcing a portion of the production process to another company. **Outsourcing** is work that is done for a company by people other than the company's full-time employees. For example, a firm that previously manufactured and packaged its product may outsource the packaging function to another company, and as a result free up factory space to increase production of the basic product. Additionally, a firm might outsource its information technology function to free up resources that could be invested in product development efforts.

Extending Product Lines A **product line extension strategy** involves making additional versions of a product so that it will appeal to different clientele or making related products to sell to the same clientele. For example, a company may make another version of a low-end product that is a little better and then make another version of it that represents the top of the line to appeal to different clientele. This is a strategy that allows a firm to take one product and extend it into several products without incurring significant additional development expense. Computer manufacturers provide a good example of how to execute a product line extension strategy. Each manufacturer sells several versions of its desktop and laptop computers. The different versions of the same computer typically represent good, better, and best alternatives based on processor speed, memory capacity, monitor size, graphic capabilities, and other features. In regard to making related products to sell to the same clientele, many firms start by offering one product or service and then expand into related areas. For example, Ben Lewis, the

student/entrepreneur profiled at the beginning of Chapter 13, started PurBlu Beverages in 2007 by selling GIVE bottled water—a basic bottled water. In 2008 he added GIVE Strength, an electrolyte-infused bottled water. In 2009, PurBlu added GIVE Energy, an all-natural energy drink. In 2010, GIVE Energy Lite, a lower-calorie version of its GIVE Energy drinks, was added to the firm's portfolio of products.

Firms also pursue product extension strategies as a way of leveraging their core competencies into related areas. For example, Zipcar has applied the expertise it developed through its consumer car sharing service to launch Zipcar for business, an initiative that allows businesses to use Zipcar's services in the same way that individuals do. Similarly, it recently launched FastFleet, a service to help cities more efficiently use cars in their fleet. An account of the history of Oracle, a computer database software company, provides a particularly interesting example of the potential payoff of a product extension strategy. The example demonstrates that product extension strategies can take time and patience to pay off but can lead to breakthrough growth strategies:

As Ellison [Oracle's CEO] recognized that he had sold a database to almost every one of the biggest companies in the world, he knew he would need new products to sell. That is how he came up with the idea of applications. Oracle applications would sit on top of and use Oracle databases to perform functions such as inventory management, personnel record keeping, and sales tracking. The proof of his thinking took almost seven years, but by 1995, the company generated nearly \$300 million in license revenues from application products and an additional \$400 million in applications-related services.⁶

Geographic Expansion **Geographic expansion** is another internal growth strategy. Many entrepreneurial businesses grow by simply expanding from their original location to additional geographic sites. This type of expansion is most common in retail settings. For example, a small business that has a successful retail store in one location may expand by opening a second location in a nearby community. Gap Inc., Walgreens, and Panera Bread are examples of firms that have grown through geographic expansion. Of course, McDonald's, which now has over 32,000 worldwide locations, is the classic example of incredibly successful growth through geographic expansion. Interestingly, Subway, another firm achieving a significant level of success through geographic expansion, now has more locations worldwide than does McDonald's. The keys to successful geographic expansion follow:

- **Perform successfully in the initial location:** Additional locations can learn from the initial location's success.
- **Establish the legitimacy of the business concept in the expansion locations:** For example, a particular type of fitness center may be well accepted in its original location because it has been there a long time and has a loyal clientele. However, potential clientele in a neighboring community may be completely unfamiliar with its unique products and services. A common mistake an entrepreneurial venture makes when it expands from one community to another is to assume that if something works in one community, it will automatically work in another.
- **Don't isolate the expansion location:** Sometimes the employees in an expansion location feel isolated and that they are not receiving adequate training and oversight from the headquarters location. It is a mistake to believe that an expansion location can excel without the same amount of attention and nurturing that it took to build the business in the original location.

International Expansion

International expansion is another common form of growth for entrepreneurial firms.⁷ According to a PricewaterhouseCoopers's survey of rapid-growth entrepreneurial firms, 46 percent of the 350 firms surveyed sell in international markets.⁸ A look at the world's population and purchasing power statistics affirms the importance of international markets for growth-oriented firms. Approximately 95 percent of the world's population and two-thirds of its total purchasing power are located outside the United States. Influenced by these data, an increasing number of the new firms launched in the United States today are international new ventures.

LEARNING OBJECTIVE

5. Explain what an "international new venture" is and describe its importance to entrepreneurial ventures.

International new ventures are businesses that, from inception, seek to derive competitive advantage by using their resources to sell products or services in multiple countries.⁹ From the time they are started, these firms, which are sometimes called "global start-ups," view the world as their marketplace rather than confine themselves to a single country. ASOS, for example, which is a fashion Web site, was an international firm from its inception. It now generates over 35 percent of its revenues from overseas sales.¹⁰ Other new firms are not international from the start, but choose to enter international markets shortly after they gain product acceptance in the United States. For example, Slingbox, which makes a product that lets people watch TV on their computers while they are away from home, was founded in 2004. Having gained favorable reaction to its product in the United States, the company started testing a beta version of its product in Europe in 2006. Slingbox now sells its product in the United States, 26 European countries, five Asian countries, and Canada.¹¹

Although there is vast potential associated with selling overseas, it is a fairly complex form of firm growth. Of course, alert entrepreneurs should carefully observe any changes in purchasing power among the world's societies that may result from a financial crisis like the one the world experienced in 2008 and 2009. Let's look at the most important issues that entrepreneurial firms should consider in pursuing growth via international expansion.

Assessing a Firm's Suitability for Growth Through International Markets Table 14.3 provides a review of the issues that should be considered, including management/organizational issues, product and distribution issues,

TABLE 14.3 EVALUATING A FIRM'S OVERALL SUITABILITY FOR GROWTH THROUGH INTERNATIONAL MARKETS

Management/Organizational Issues

Depth of management commitment. A firm's first consideration is to test the depth of its management commitment to entering international markets. Although a firm can "test the waters" by exporting with minimal risk, other forms of internationalization involve a far more significant commitment. A properly funded and executed international strategy requires top management support.

Depth of international experience. A firm should also assess its depth of experience in international markets. Many entrepreneurial firms have no experience in this area. As a result, to be successful, an inexperienced entrepreneurial firm may have to hire an export management company to familiarize itself with export documentation and other subtleties of the export process. Many entrepreneurial firms err by believing that selling and servicing a product or service overseas is not that much different than doing so at home. It is.

Interference with other firm initiatives. Learning how to sell in foreign markets can consume a great deal of entrepreneurs' or managers' time. Overseas travel is often required, and selling to buyers who speak a different language and live in a different time zone can be a painstaking process. Overall, efforts must be devoted to understanding the culture of the international markets the venture is considering. Thus, a firm should weigh the advantages of involvement in international markets against the time commitment involved and the potential interference with other firm initiatives.

TABLE 14.3 CONTINUED**Product and Distribution Issues**

Product issues. A firm must first determine if its products or services are suitable for overseas markets. Many pertinent questions need to be answered to make this determination. For example, are a firm's products subject to national health or product safety regulations? Do the products require local service, supplies, or spare parts distribution capability? Will the products need to be redesigned to meet the specifications of customers in foreign markets? Will foreign customers find the products desirable? All these questions must have suitable answers before entering a foreign market. A firm can't simply "assume" that its products are salable and easily serviceable in foreign countries.

Distribution issues. How will the product be transported from the United States to a foreign country? Alternatively, how would an entrepreneurial firm transport a product produced in Sweden to a market in the United States? Is the transportation reliable and affordable? Can the product be exported from the venture's home operation, or will it have to be manufactured in the country of sale?

Financial and Risk Management Issues

Financing export operations. Can the foreign initiative be funded from internal operations, or will additional funding be needed? How will foreign customers pay the firm? How will the firm collect bad debts in a foreign country? Informed answers to these questions must be obtained before the firm initiates overseas sales.

Foreign currency risk. How will the firm manage fluctuations in exchange rates? If the entrepreneurial firm is located in America and it sells to a buyer in Japan, will the American firm be paid in U.S. dollars or in Japanese yen?

and financial and risk management issues, when a venture considers expanding into international markets. If these issues can be addressed successfully, growth through international markets may be an excellent choice for an entrepreneurial firm. The major impediment in this area is not fully appreciating the challenges involved.

Foreign Market Entry Strategies The majority of entrepreneurial firms first enter foreign markets as exporters, but firms also use licensing, joint ventures, franchising, turnkey projects, and wholly owned subsidiaries to start international expansion.¹² These strategies, along with their primary advantages and disadvantages, are explained in Table 14.4.

Selling Overseas Many entrepreneurial firms first start selling overseas by responding to an unsolicited inquiry from a foreign buyer. It is important to handle the inquiry appropriately and to observe protocols when trying to serve the needs of customers in foreign markets. Following are several rules of thumb for selling products in foreign markets:

- Answer requests promptly and clearly. Do not ignore a request just because it lacks grammatical clarity and elegance. Individuals using a nonnative language to contact a business located outside their home nation often are inexperienced with a second language.
- Replies to foreign inquires, other than e-mail or fax, should be communicated through some form of airmail or overnight delivery. Ground delivery is slow in some areas of the world.
- A file should be set up to retain copies of all foreign inquiries. Even if an inquiry does not lead to an immediate sale, the names of firms that have made inquiries will be valuable for future prospecting.
- Keep promises. The biggest complaint from foreign buyers about U.S. businesses is failure to ship on time (or as promised). The first order is the most important in that it sets the tone for the ongoing relationship.
- All correspondence should be personally signed. Form letters are offensive in some cultures.

TABLE 14.4 PRIMARY ADVANTAGES AND DISADVANTAGES OF VARIOUS FOREIGN-MARKET ENTRY STRATEGIES

Foreign-Market Entry Strategy	Primary Advantage	Primary Disadvantage
Exporting. Exporting is the process of producing a product at home and shipping it to a foreign market. Most entrepreneurial firms begin their international involvement as exporters.	Exporting is a relatively inexpensive way for a firm to become involved in foreign markets.	High transportation costs can make exporting uneconomical, particularly for bulky products.
Licensing. A licensing agreement is an arrangement whereby a firm with the proprietary rights to a product grants permission to another firm to manufacture that product for specified royalties or other payments. Proprietary services and processes can also be licensed.	The licensee puts up most of the capital needed to establish the overseas operation.	A firm in effect “teaches” a foreign company how to produce its proprietary product. Eventually, the foreign company will probably break away and start producing a variation of the product on its own.
Joint ventures. A joint venture involves the establishment of a firm that is jointly owned by two or more otherwise independent firms. Fuji-Xerox, founded in 1962, for example, is a joint venture between an American and a Japanese firm.	Gaining access to the foreign partner’s knowledge of local customs and market preferences.	A firm loses partial control of its business operations.
Franchising. A franchise is an agreement between a franchisor (the parent company that has a proprietary product, service, or business method) and a franchisee (an individual or firm that is willing to pay the franchisor a fee for the right to sell its product, service, and/or business method). U.S. firms can sell franchises in foreign markets, with the reverse being true as well.	The franchisee puts up the majority of capital needed to operate in the foreign market.	Quality control.
Turnkey projects. In a turnkey project, a contractor from one country builds a facility in another country, trains the personnel that will operate the facility, and <i>turns</i> over the keys to the project when it is completed and ready to operate.	Ability to generate revenue.	It is usually a one-time activity, and the relationships that are established in a foreign market may not be valuable to facilitate future projects.
Wholly owned subsidiary. A firm that establishes a wholly owned subsidiary in a foreign country has typically made the decision to manufacture in the foreign country and establish a permanent presence.	Provides a firm total control over its foreign operations.	The cost of setting up and maintaining a manufacturing facility and permanent presence in a foreign country can be high.

- Be polite, courteous, friendly, and respectful. This is simple common sense, but politeness is particularly important in some Asian cultures. In addition, avoid the use of business slang that is indigenous to the United States, in that the slang terms lack meaning in many other cultures. Stated simply, be sensitive to cultural norms and expectations.
- For a personal meeting, always make sure to send an individual who is of equal rank to the person with whom he or she will be meeting. In some cultures, it would be seen as inappropriate for a salesperson from a U.S. company to meet with the vice president or president of a foreign firm.

EXTERNAL GROWTH STRATEGIES

External growth strategies rely on establishing relationships with third parties, such as mergers, acquisitions, strategic alliances, joint ventures, licensing, and franchising. Thus, joint ventures, licensing, and franchising are strategic options entrepreneurial firms use to both enter foreign markets (as explained

previously) and accomplish external growth. Each of these strategic options is discussed in the following sections, with the exception of franchising, which we consider separately in Chapter 15.

An emphasis on external growth strategies typically results in a more fast-paced, collaborative approach toward growth than the slower-paced internal strategies, such as new product development and expanding to foreign markets. External growth strategies level the playing field between smaller firms and larger companies.¹³ For example, Pixar, the small animation studio that produced the animated hits *Toy Story*, *Finding Nemo*, and *Up*, had a number of key strategic alliances with Disney, before Disney acquired Pixar in 2006. By partnering with Disney, Pixar effectively co-opted a portion of Disney's management savvy, technical expertise, and access to distribution channels. The relationship with Disney helped Pixar grow and enhance its ability to effectively compete in the marketplace, to the point where it became an attractive acquisition target. Similarly, by acquiring other companies, relatively young firms such as Pixar can gain access to patents and proprietary techniques that take larger firms years to develop on their own.

There are distinct advantages and disadvantages to emphasizing external growth strategies, as shown in Table 14.5.

TABLE 14.5 ADVANTAGES AND DISADVANTAGES OF EMPHASIZING EXTERNAL GROWTH STRATEGIES

Advantages	Disadvantages
<p>Reducing competition. Competition is lessened when a firm acquires a competitor. This step often helps a firm establish price stability by eliminating the possibility of getting in a price war with at least one competitor. By turning potential competitors into partners and through alliances and franchises, the firm can also reduce the amount of competition it experiences.</p>	<p>Incompatibility of top management. The top managers of the firms involved in an acquisition, an alliance, a licensing agreement, or a franchise organization may clash, making the implementation of the initiative difficult.</p>
<p>Getting access to proprietary products or services. Acquisitions or alliances are often motivated by a desire on the part of one firm to gain legitimate access to the proprietary property of another.</p>	<p>Clash of corporate cultures. Because external forms of growth require the combined effort of two or more firms, corporate cultures often clash, resulting in frustration and subpar performance.</p>
<p>Gaining access to new products and markets. Growth through acquisition, alliances, or franchising is a quick way for a firm to gain access to new products and markets. Licensing can also provide a firm an initial entry into a market.</p>	<p>Operational problems. Another problem that firms encounter when they acquire or collaborate with another company is that their equipment and business processes may lack full compatibility.</p>
<p>Obtaining access to technical expertise. Sometimes, businesses acquire or partner with other businesses to gain access to technical expertise. In franchise organizations, franchisors often receive useful tips and suggestions from their franchisees.</p>	<p>Increased business complexity. Although the vast majority of acquisitions and alliances involve companies that are in the same or closely related industries, some entrepreneurial firms acquire or partner with firms in unrelated industries. This approach vastly increases the complexity of the combined business. The firm acquiring a brand or partnership with another company to gain access to its brand may subsequently fail to further develop its own brand and trademarks. This failure can lead to an increased dependency on acquired or partnered brands, reducing the firm's ability to establish and maintain a unique identity in the marketplace.</p>
<p>Gaining access to an established brand name. A growing company that has good products or services may acquire or partner with an older, more established company to gain access to its trademark and name recognition.</p>	<p>Loss of organizational flexibility. Acquiring or establishing a partnership with one firm may foreclose the possibility of acquiring or establishing a partnership with another one.</p>
<p>Economies of scale. Combining two or more previously separate firms, whether through acquisition, partnering, or franchising, often leads to greater economies of scale for the combined firms.</p>	<p>Antitrust implications. Acquisitions and alliances are subject to antitrust review. In addition, some countries have strict antitrust laws prohibiting certain business relationships between firms.</p>
<p>Diversification of business risk. One of the principal driving forces behind all forms of collaboration or shared ownership is to diversify business risk.</p>	

Mergers and Acquisitions

LEARNING OBJECTIVE

6. Discuss the objectives a company can achieve by acquiring another business.

Many entrepreneurial firms grow through mergers and acquisitions. A **merger** is the pooling of interests to combine two or more firms into one. An **acquisition** is the outright purchase of one firm by another. In an acquisition, the surviving firm is called the **acquirer**, and the firm that is acquired is called the **target**. This section focuses on acquisitions rather than mergers because entrepreneurial firms are more commonly involved with acquisitions than mergers.

Acquiring another business can fulfill several of a company's needs, such as expanding its product line, gaining access to distribution channels, achieving economies of scale, gaining access to technology that will enhance its current offerings, or gaining access to talented employees. In most cases, a firm acquires a competitor or a company that has a product line or distinctive competency that it needs. For example, in 2010 Facebook acquired photo site Divvyshot as a way of enhancing its existing photo sharing site. Similarly, in 2008 Twitter acquired a company called Summize to bring search into Twitter. Summize also had a highly talented engineering team that Twitter was anxious to get its hands on.¹⁴

Although it can be advantageous, the decision to grow the entrepreneurial firm through acquisitions should be approached with caution.¹⁵ Many firms have found that the process of assimilating another company into their current operation is not easy and can stretch finances to the brink.

Finding an Appropriate Acquisition Candidate If a firm decides to grow through acquisition, it is extremely important for it to exercise extreme care in finding acquisition candidates. Many acquisitions fail not because the companies involved lack resolve, but because they were a poor match to begin with. There are typically two steps involved in finding an appropriate target firm. The first step is to survey the marketplace and make a "short list" of promising candidates. The second is to carefully screen each candidate to determine its suitability for acquisition. The key areas to focus on in accomplishing these two steps are as follows:

LEARNING OBJECTIVE

7. Identify a promising acquisition candidate's characteristics.

- The target firm's openness to the idea of being acquired and its ability to receive consent for its acquisition from key third parties. The third parties from whom consent may be required include bankers, investors, suppliers, employees, and key customers.
- The strength of the target firm's management team, its industry, and its physical proximity to the acquiring firm's headquarters.
- The perceived compatibility of the target company's top management team and its corporate culture with the acquiring firm's top management team and corporate culture.
- The target firm's past and projected financial performance.
- The likelihood the target firm will retain its key employees and customers if acquired.
- The identification of any legal complications that might impede the purchase of the target firm and the extent to which patents, trademarks, and copyrights protect the firm's intellectual property.
- The extent to which the acquiring firm understands the business and industry of the target firm.

The screening should be as comprehensive as possible to provide the acquiring firm sufficient data to determine realistic offering prices for the firms under consideration. A common mistake among acquiring firms is to pay too much for the businesses they purchase. Firms can avoid this mistake by basing their bids on hard data rather than on guesses or intuition.

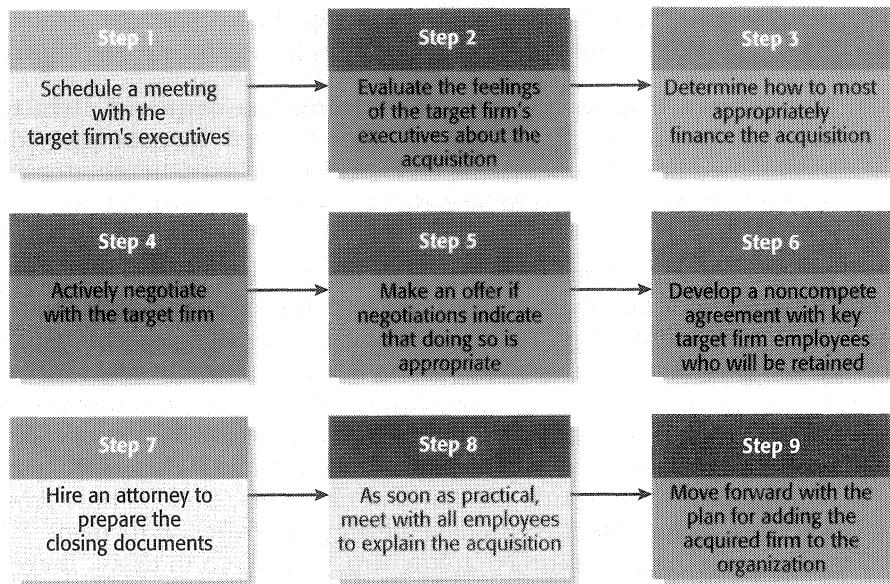


FIGURE 14.2
The Process of
Completing the
Acquisition of Another
Firm

Based on *Wall Street Journal*
(Eastern Edition) by C.
DeBaise. Copyright 2007 by
Dow Jones & Company Inc.

Steps Involved in an Acquisition Completing an acquisition is a nine-step process, as illustrated in Figure 14.2:

- Step 1 Schedule a meeting with the target firm's executives:** The acquiring firm should have legal representation at this point to help structure the initial negotiations and help settle any legal issues. The acquiring firm should also have a good idea of what it thinks the acquisition target is worth.
- Step 2 Evaluate the feelings of the target firm's executives about the acquisition:** If the target is in a "hurry to sell," it works to the acquiring firm's advantage. If the target starts to get cold feet, the negotiations may become more difficult.
- Step 3 Determine how to most appropriately finance the acquisition:** The acquiring firm should be financially prepared to complete the transaction if the terms are favorable.
- Step 4 Actively negotiate with the target firm:** If a purchase is imminent, obtain all necessary shareholder and third-party consents and approvals.
- Step 5 Make an offer if negotiations indicate that doing so is appropriate:** Both parties should have the offer reviewed by attorneys and certified public accountants that represent their interests. Determine how payment will be structured.
- Step 6 Develop a noncompete agreement with key target firm employees who will be retained:** This agreement, as explained in Chapter 7, limits the rights of the key employees of the acquired firm to start the same type of business in the acquiring firm's trade area for a specific amount of time.
- Step 7 Hire an attorney to prepare the closing documents:** Complete the transaction.
- Step 8 As soon as practical, meet with all employees to explain the acquisition:** A meeting should be held as soon as possible with the

employees of both the acquiring firm and the target firm. Articulate a vision for the combined firm and ease employee anxiety where possible.

Step 9 Move forward with the plan for adding the acquired firm to the organization: In some cases, the acquired firm is immediately assimilated into the operations of the acquiring firm. In other cases, the acquired firm is allowed to operate in a relatively autonomous manner.

Along with acquiring other firms to accelerate their growth, entrepreneurial firms are often the targets of larger firms that are looking to enter a new market or acquire proprietary technology. Selling to a large firm is often the goal of an investor-backed company, as a way of creating a liquidity event to allow investors to monetize their investment. Some entrepreneurs allow their companies to be bought by larger firms as a way of accelerating their growth. For example, in 2008 Honest Tea sold a large stake of itself to Coca-Cola, primarily as a means of integrating itself into Coke's worldwide distribution channels. Coke is now providing Honest Tea access to markets it could have never penetrated on its own.

In 2007 StumbleUpon, an Internet start-up, sold itself to eBay. Incredibly, just two years later StumbleUpon's founder and a group took it private again. The reasons for the abrupt turnaround are chronicled in the "What Went Wrong?" feature that follows. The feature is a reminder that acquisitions are complex and don't always work out as envisioned.

WHAT WENT WRONG?

Be Careful What You Wish For: How StumbleUpon's Founder Sold His Company to eBay and Two Years Later Bought It Back Again

Web: www.stumbleupon.com

Twitter: [StumbleUpon](#)

Facebook: [StumbleUpon](#)

For two main reasons, many entrepreneurial firms aspire to be bought by larger companies. First, by selling to a large firm, an entrepreneurial venture is able to create a liquidity event for its investors. Second, being acquired by a large company often allows a small firm to accelerate its growth and make good progress toward achieving its mission. Typically, a small firm often doesn't have the marketing and distribution muscle to get wide market exposure. By selling to a large firm, a small firm's products can take off by being integrated into the larger firm's marketing program and distribution channels.

In 2007 StumbleUpon, an Internet start-up, sold itself to eBay for \$75 million. StumbleUpon is a discovery engine (a form of Web search engine) that finds and recommends Web sites to its users. It was founded in 2001 by Garrett Camp and three friends while Camp was pursuing a masters' degree at the University of Calgary. StumbleUpon's service grew in popularity over time and attracted \$1.2 million in investment capital. The setup of its service allows users to "stumble upon" Web sites that they normally wouldn't have known about. People who are passionate about StumbleUpon's site say they like it

because of the surprise factor of what they see next. StumbleUpon makes money via targeted advertising. The sites a user stumbles upon are not entirely random. Advertisers can buy placements from StumbleUpon that ensure a certain number of page views from StumbleUpon users each day.

Unlike the rationale for a larger firm buying a small firm provided previously, it was never entirely clear why eBay bought StumbleUpon. The most likely scenario is that eBay felt it could grow StumbleUpon and benefit from its increased ad revenue. It was also thought that eBay might use StumbleUpon's functionality to help eBay customers stumble through eBay's listings, and potentially buy things they wouldn't have thought to buy through the fun of discovering them via the "stumble across" format. Incredibly, just two years after eBay bought StumbleUpon, its founder, Garrett Camp, and a group of investors bought it back, meaning that StumbleUpon is again a private company. What went wrong?

In a very transparent interview with the *Wall Street Journal*, Garrett Camp chronicled the reasons the eBay

acquisition didn't work out. Camp and the majority of his team stuck with StumbleUpon during the two years it was owned by eBay, working on StumbleUpon as eBay employees. StumbleUpon was able to operate fairly autonomously, although it was part of eBay and subject to eBay's oversight and administrative rules.

There were two categories of problems that prompted Camp to repurchase StumbleUpon from eBay. First, by being part of a large company, Camp and his team lost lots of flexibility and control—in making decisions, troubleshooting problems, and hiring employees. In short, they felt StumbleUpon's entrepreneurial fire was being smothered. Little things were also troublesome. For example, when they sent an offer letter to a job candidate it went out on eBay letterhead. They asked if they could put StumbleUpon's logo on the letter, but there wasn't a procedure to allow that to happen.

The second category of problems dealt with recruiting and hiring high-potential employees. First, the process of hiring was slower inside eBay than it was when StumbleUpon was an independent firm. That put StumbleUpon at a disadvantage when job candidates it was competing for were getting instant offers from private firms. Second, the stock price for a large company like eBay is fairly stable. That made it difficult for StumbleUpon to compete for top engineering talent. By going to work for a start-up or growing private firm, an engineer's stock options are likely to accelerate in value much more quickly than working for a large firm like eBay.

Fortunately, this "What Went Wrong?" feature has a happy ending, at least from StumbleUpon's perspective. In late 2010, the firm announced that it had signed up its

10 millionth user, and said its number of advertisers climbed by 20 percent and its headcount by over 50 percent in 2010. StumbleUpon recently launched an iPhone and Android app as well.

Questions for Critical Thinking

1. Of the issues that were problematic for Camp and his team, in regard to growing StumbleUpon as an eBay subsidiary rather than as an independent firm, what single issue do you think was the most problematic?
2. Why do you think eBay allowed Camp and his investors to take StumbleUpon private again? Do you think there were frustrations on eBay's part in working with Camp and his team?
3. What lessons does this feature teach the founders of rapidly growing entrepreneurial firms that are likely acquisition targets?
4. The "You Be the VC 14.2" feature focuses on thredUP, an online platform for the parents of growing children to exchange the clothes their children grow out of for clothes their children need. Identify a large company that might purchase thredUP if thredUP does well. From thredUP's point of view, make a list of the advantages and disadvantage of being acquired by that company.

Sources: Jeanette Borzo, "The Perils of Being the Little Fish," *Wall Street Journal*, November 15, 2010, p. B2; Mathew Ingram, "Update: StumbleUpon—Not Much Attention, but Big Traffic." *GigaOM blog*, <http://gigaom.com/2010/09/03/stumbleupon-and-fark-not-much-attention-but-big-traffic> (accessed March 15, 2011, originally posted on September 3, 2010).

Licensing

Licensing is the granting of permission by one company to another company to use a specific form of its intellectual property under clearly defined conditions. Virtually any intellectual property a company owns that is protected by a patent, trademark or copyright can be licensed to a third party. Licensing also works well for firms that create novel products but do not have the resources to build manufacturing capabilities or distribution networks, which other firms may already have in place. For example, Phone Halo, the business profiled at the beginning of the chapter, has adopted a licensing model. Instead of producing the Phone Halo mobile app and hardware device itself, the company is licensing the products to third parties that already have manufacturing capabilities and distribution networks available.

Entrepreneurial firms can also benefit by licensing technology from larger companies. For example Mint.com, the subject of Case 14.1, licenses technology from Yodlee, a larger firm. Yodlee's technology enables Mint.com to access its members' account information, like credit card balances and payment due dates. Recall Wesabe, the subject of the "Went Went Wrong" feature in Chapter 13, tried to build a personal financial management Web site similar to Mint.com and decided to build its own capabilities for scrapping bank Web sites rather than license the technology from Yodlee. Marc Hedlund, one of Wesabe's cofounders, attributes this decision to one of the reasons Wesabe failed.

LEARNING OBJECTIVE

8. Explain "licensing" and how it can be used as a growth strategy.

The terms of a license are spelled out through a **licensing agreement**, which is a formal contract between a licensor and a licensee. The **licensor** is the company that owns the intellectual property; the **licensee** is the company purchasing the right to use it. A license can be exclusive, nonexclusive, for a specific purpose, and for a specific geographic area.¹⁶ In almost all cases, the licensee pays the licensor an initial payment plus an ongoing royalty for the right to use the intellectual property. There is no set formula for determining the amount of the initial payment or the royalties—these are issues that are part of the process of negotiating a licensing agreement.¹⁷ Entrepreneurial firms often press for a relatively large initial payment as a way of generating immediate cash to fund their operations.

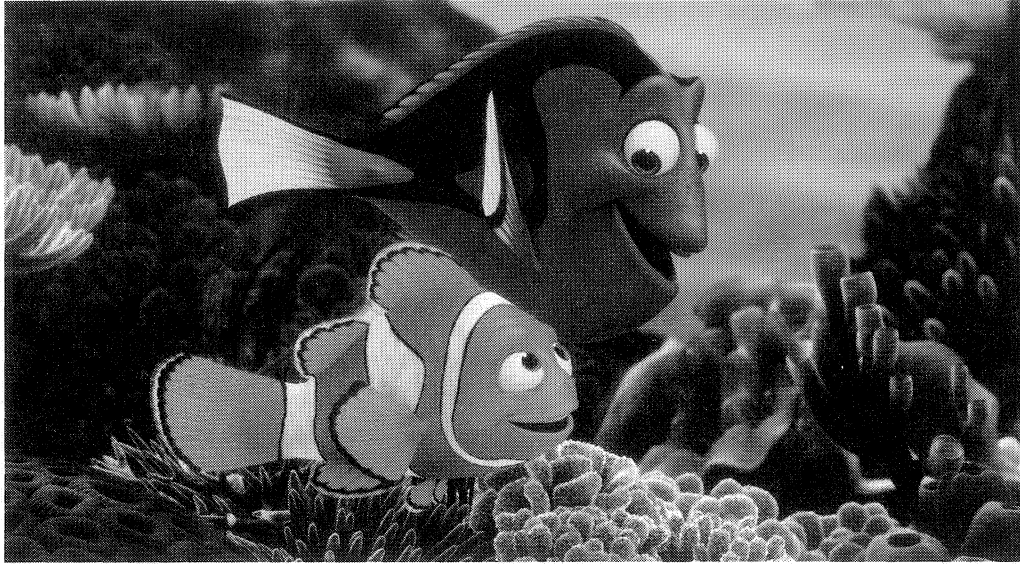
There are two principal types of licensing: technology licensing and merchandise and character licensing.

Technology Licensing **Technology licensing** is the licensing of proprietary technology that the licensor typically controls by virtue of a utility patent. This type of licensing agreement commonly involves one of two scenarios. First, firms develop technologies to enhance their own products and then find noncompetitors to license the technology to spread out the costs and risks involved. Second, companies that are tightly focused on developing new products pass on their new products through licensing agreements to companies that are more marketing oriented and that have the resources to bring the products to market.

Striking a licensing agreement with a large firm can involve tough negotiations. An entrepreneur should carefully investigate potential licensees to make sure they have a track record of paying licensing fees on time and are easy to work with. To obtain this information, it is appropriate to ask a potential licensee for references. It is also important that an entrepreneur not give away too much in regard to the nature of the proprietary technology in an initial meeting with a potential licensee. This challenge means finding the right balance of piquing a potential licensee's interest without revealing too much. Nondisclosure agreements, described in Chapter 7, should be used in discussing proprietary technologies with a potential licensee.

Merchandise and Character Licensing **Merchandise and character licensing** is the licensing of a recognized trademark or brand that the licensor typically controls through a registered trademark or copyright. For example, Harley-Davidson licenses its trademark to multiple companies that place the Harley trademark on T-shirts, jackets, collectibles, gift items, jewelry, watches, bike accessories, and so on. By doing this, Harley not only generates licensing income but also promotes the sale of Harley-Davidson motorcycles. Similarly, entrepreneurial firms such as eBay and Starbucks license their trademarks not only to earn licensing income but also to promote their products or services to a host of current and potential customers.

The key to merchandise and character licensing is to resist the temptation to license a trademark too widely and to restrict licensing to product categories that have relevance and that appeal to a company's customers. If a company licenses its trademark too broadly, it can lose control of the quality of the products with which its trademark is identified. This outcome can diminish the strength of a company's brand. For example, a company such as ModCloth might license its trademark to a watch manufacturer that is interested in producing a line of ModCloth women's watches. ModCloth would want to make sure that the watches bearing its trademark were fashionable, were of similar quality to its clothing, and were appealing to its clientele. ModCloth can enforce these standards through the terms of its licensing agreements.



Disney Enterprises/Album/Newscom

Character licensing represents a major source of income and growth for a film company like Pixar, which is now a division of Walt Disney Corporation. Familiar characters from the film *Finding Nemo*, including Marlin (left) and Dory (right), now adorn products as varied as T-shirts, dinner plates, lunch bags, and children's bedspreads.

Strategic Alliances and Joint Ventures

The increase in the popularity of strategic alliances and joint ventures has been driven largely by a growing awareness that firms can't "go it alone" and succeed.¹⁸ As with all forms of firm growth, strategic alliances and joint ventures have advantages and disadvantages. We present these points in Table 14.6.

Strategic Alliances A **strategic alliance** is a partnership between two or more firms that is developed to achieve a specific goal. Various studies show that participation in alliances can boost a firm's rate of patenting,¹⁹ product innovation,²⁰ and foreign sales.²¹ Alliances tend to be informal and do not involve the creation of a new entity (such as in a joint venture). Although engaging in alliances can be tremendously helpful for an entrepreneurial firm, setting up an alliance and making it work can be tricky. This dimension of alliances is highlighted in the "Partnering for Success" feature shown on the following two pages.

Technological alliances and marketing alliances are two of the most common forms of alliances.²² **Technological alliances** feature cooperation in research and development, engineering, and manufacturing. Research-and-development alliances often bring together entrepreneurial firms with specific technical skills and larger, more mature firms with experience in development and marketing. By pooling their complementary assets, these firms can typically produce a product and bring it to market faster and cheaper than either firm could alone.²³ Pfizer's blockbuster drug Celebrex, for example, was created via a technological alliance. Celebrex is a prescription arthritis medicine. **Marketing alliances** typically match a company with a distribution system with a company that has a product to sell in order to increase sales of a product or service. For example, an American food company may initiate an alliance with Nestlé (a Swiss food company) to gain access to Nestlé's distribution channels in Europe. The strategic logic of this type of alliance for both partners is simple. By finding more outlets for its products, the partner that is supplying the product can increase economies of scale and reduce per unit cost. The partner that supplies the distribution channel benefits by adding products to its product line, increasing its attractiveness to those wanting to purchase a wide array of products from a single supplier.

Both technological and marketing alliances allow firms to focus on their specific area of expertise and partner with others to fill their expertise gaps. This approach is particularly attractive to entrepreneurial firms, which often

LEARNING OBJECTIVE

9. Explain "strategic alliances" and describe the difference between technological alliances and marketing alliances.

TABLE 14.6 ADVANTAGES AND DISADVANTAGES OF PARTICIPATING IN STRATEGIC ALLIANCES AND JOINT VENTURES

Advantages	Disadvantages
<p>Gain access to a particular resource. Firms engage in strategic alliances and joint ventures to gain access to a particular resource, such as capital, employees with specialized skills, or modern production facilities.</p>	<p>Loss of proprietary information. Proprietary information can be lost to a partner who is already a competitor or will eventually become one. This is a common worry.</p>
<p>Economies of scale. In many industries, high fixed costs require firms to find partners to expand production volume as a means of developing economies of scale.</p>	<p>Management complexities. Because strategic alliances and joint ventures require the combined effort of two or more firms, managing them can be challenging. Frustrations and costly delays often occur as a result.</p>
<p>Risk and cost sharing. Strategic alliances and joint ventures allow two or more firms to share the risk and cost of a particular business endeavor.</p>	<p>Financial and organizational risks. The failure rate for strategic alliances and joint ventures is high.</p>
<p>Gain access to a foreign market. Partnering with a local company is often the only practical way to gain access to a foreign market.</p>	<p>Risk becoming dependent on a partner. A power imbalance arises if one partner becomes overly dependent on the other. This situation increases the potential for opportunism on the part of the stronger partner. Opportunistic behavior takes advantage of a partner.</p>
<p>Learning. Strategic alliances and joint ventures often provide the participants the opportunity to “learn” from their partners.</p>	<p>Partial loss of decision autonomy. Joint planning and decision making may result in a loss of decision autonomy.</p>
<p>Speed to market. Firms with complementary skills, such as one firm being technologically strong and another having strong market access, partner to increase speed to market in hopes of capturing first-mover advantages.</p>	<p>Partners’ cultures may clash. The corporate cultures of alliance partners may clash, making the implementation and management of the alliance difficult.</p>
<p>Neutralizing or blocking competitors. Through strategic alliances and joint ventures, firms can gain competencies and market power that can be used to neutralize or block a competitor’s actions.</p>	<p>Loss of organizational flexibility. Establishing a partnership with one firm may foreclose the possibility of establishing a partnership with another firm.</p>

Based on B. R. Barringer and J. S. Harrison, “Walking a Tightrope: Creating Value Through Interorganizational Relationships,” *Journal of Management* 26, no. 3 (2002): 367–403.

PARTNERING FOR SUCCESS

Three Steps to Alliance Success

Although strategic alliances are an increasingly popular way for entrepreneurial firms to accelerate growth, they should be approached strategically and carefully. A failed alliance can cause a firm to lose money and can be very time consuming and frustrating to exit from. Alliances are often compared to marriages and other close relationships: easy to get into but very hard to get out of—at least gracefully.

There are three key steps in setting up and executing a successful alliance relationship. The following are the three steps, along with words of advice on how to handle each one.

Selecting a Partner

Any company or group of companies that has something a firm needs is a potential alliance partner. For example, small food companies often partner with large food

companies to gain access to their distribution channels. But a company should remember that a potential partner is looking for a leg up too in the form of some type of advantage while competing in the marketplace. If the small food company has to give the large food company “exclusive” distribution rights to its best products to get the deal, it may not be worth it. Entering into an alliance should improve a company’s situation—it shouldn’t be a jump ball. Alliances take a great deal of effort to manage and certainly to manage successfully. If each company in an alliance breaks even in terms of outcomes, the alliance is not usually worth it, because of the time and effort it takes from other activities.

Also, a firm should always investigate the reputation of the companies it is thinking about partnering with. Asking for references of other businesses the company is partnering with is appropriate, even if the company

is well known. If a company is reluctant or unwilling to provide references, look elsewhere.

According to Guy Kawasaki, a respected Silicon Valley entrepreneur and venture capitalist, most companies form alliances for the wrong reason: to make the press and analysts happy. Kawasaki says this is foolish. Alliances should be formed for one of two reasons in Kawasaki's opinion: to either increase revenues or decrease costs.

Cutting the Deal

Negotiating an alliance can take multiple meetings, conference calls, and e-mail messages. So it's best to cut to the chase, as early as possible, to discern if a deal is possible. It's easy for a small firm to get sucked into months of negotiations with a large company like Microsoft or Google, only to have the deal fall through. It probably won't hurt Microsoft or Google if a handful of its employees lose time failing to negotiate an alliance agreement with a small firm. The lost time on the part of the small firm may be much more damaging.

The most important consideration in cutting a deal is to make sure the potential partners truly have synergies (i.e., $2 + 2 = 5$), and that the synergies are sustainable. Otherwise, experts agree, "no contract will hold them together." Also, firms should be leery of entering into an alliance if there is any hint that the people who will actually implement the alliance aren't totally on board. The worst-case scenario is two CEOs who meet at a conference and start talking about their two firms "working together." If they start kicking around alliance ideas that don't make sense, the midlevel people in an organization need to be empowered to hold their ground. The people who have to implement the alliance, for both organizations, should be heard. If they're less than enthused about an alliance proposal, it should be scrapped.

If an alliance agreement is struck, it should be accompanied by a set of operating principles that guide its day-to-day operation. It's also smart to include an "out" clause, which allows each party in the alliance to terminate its involvement relatively easily.

Making It Work

The biggest obstacle to making an alliance work is that the corporate cultures of organizations often vary in substantially important ways. As a result, the first thing

that should be determined when deciding how to manage an alliance is how decisions are made. A start-up may be used to making decisions on the fly, while a large company partner may route decisions through several committees before a final decision is made. Unless the partners know what to expect, frustrations can result.

Each alliance partner should also appoint an internal "champion" who has direct responsibility for the alliance's health and progress. "A bunch of people helping out when they can" doesn't cut it. An alliance should have a boss inside each involved organization, just like employees have bosses.

The individuals who will make the alliance work for all the parties involved should also meet face to face. It's normally easier for people to trust one another and work together across distances if they've met at least one time and have had an opportunity to get to know one another as individuals.

Questions for Critical Thinking

1. In what ways is it easy for the founder of a firm to get caught up in the potential advantages of participating in alliances without remaining equally focused on the potential disadvantages?
2. Think about the partnership arrangements you've been involved with, even if your experience has been limited to working with other students in team settings in classes. What are some of the challenges in making alliances work that are not mentioned in the feature?
3. Do some Internet research and find an example of an alliance between a small firm and a large firm that seems to be working well. Briefly describe the nature of the alliance and explain its success.
4. The "You Be the VC 14.1" feature focuses on Cityscape Farms, a start-up that's creating urban greenhouse systems for year-round production of sustainable local fresh foods. Brainstorm three to five likely alliance partners for Cityscape Farms. Explain how each partner can help Cityscape either increase its revenue or decrease its costs.

Sources: "Inc. Guidebook, Build Business Alliances," *Inc.*, June 1, 2010; Guy Kawasaki, "The Art of Partnering," How to Change the World, http://blog.guykawasaki.com/2006/02/the_art_of_part.html#axzz1IOLXJ1Sv (accessed April 1, 2011, originally posted on February 6, 2006).

don't have the financial resources or time to develop all the competencies they need to bring final products to market quickly. Michael Dell describes the early years of Dell Inc.:

As a small start-up, we didn't have the money to build the components [used to make up a PC] ourselves. But we also asked, "Why should we want to?" Unlike many of our competitors, we actually had an option: to buy components from the specialists, leveraging the investments they had already made and allowing us to focus on what we did best—designing and delivering solutions and systems directly to customers. In forging these early alliances with suppliers, we created exactly the right strategy for a fast-growing company.²⁴

LEARNING OBJECTIVE

10. Explain “joint ventures” and describe the difference between a scale joint venture and a link joint venture.

Joint Ventures A **joint venture** is an entity created when two or more firms pool a portion of their resources to create a separate, jointly owned organization.²⁵ An example is Beverage Partners Worldwide, which is a joint venture between Coca-Cola and Nestlé. The joint venture markets ready-to-drink chilled teas based on green tea and black tea in more than 40 countries worldwide.

Gaining access to a foreign market is a common reason to form a joint venture.²⁶ In these cases, the joint venture typically consists of the firm trying to reach a foreign market and one or more local partners. Joint ventures created for reasons other than foreign market entry are typically described as either scale or link joint ventures.²⁷ In a **scale joint venture**, the partners collaborate at a single point in the value chain to gain economies of scale in production or distribution. This type of joint venture can be a good vehicle for developing new products or services. In a **link joint venture**, the position of the parties is not symmetrical, and the objectives of the partners may diverge. For example, many of the joint ventures between American and Canadian food companies provide the American partner with access to Canadian markets and distribution channels and the Canadian partner with the opportunity to add to its product line.

A hybrid form of joint venture that some larger firms utilize is to take small equity stakes in promising young companies. In these instances, the large companies act in the role of corporate venture capitalists, as explained in Chapter 10. Intel officially established a venture capital program in the early 1990s, named Intel Capital. Investing in private companies, this program seeks to help start-up ventures grow from their initial stages to a point of either issuing an initial public offering or being acquired. Notable investments, many of which deal with companies outside the United States, include Actions Semiconductor (a Chinese firm), MySQL (a Swedish firm), Research In Motion (a Canadian firm that makes the popular BlackBerry), and WebMD.²⁸ Firms typically make investments of this nature in companies with the potential to be either suppliers or customers in the future. The equity stake provides the large company a “say” in the development of the smaller firm. On occasion, the larger firm that has a small equity stake will acquire the smaller firm. These transactions are called **spin-ins**. The opposite of a spin-in is a **spin-out**, which occurs when a larger company divests itself of one of its smaller divisions and the division becomes an independent company. Hewlett-Packard, for example, spun off its test-and-measurement equipment division, as Agilent Technologies, which advertises itself as the “world’s premiere measurement company.”

CHAPTER SUMMARY

1. Internal growth strategies rely on efforts generated within the firm itself, such as new product development, other product-related strategies, international expansion, and Internet-driven strategies. External growth strategies rely on establishing relationships with third parties, such as mergers, licensing, strategic alliances, joint ventures, and franchising.
2. The keys to effective new product development are as follows: find a need and fill it, develop products that add value, get quality and pricing right, focus on a specific target market, and conduct an ongoing feasibility analysis.
3. The reasons that new products fail include an inadequate feasibility analysis, overestimation of market potential, bad timing (i.e., introducing a product at the wrong time), inadequate advertising and promotion, and poor service.
4. A market penetration strategy seeks to increase the sales of a product or service through greater marketing efforts or through increased production capacity and efficiency.
5. International new ventures are businesses that, from inception, seek to derive significant competitive advantage from the use of resources and the sale of outputs in multiple countries.

6. Acquiring another business can fulfill several of a company's needs, such as expanding its product line, gaining access to distribution channels, achieving competitive economies of scale, or expanding the company's geographic reach.
7. A promising acquisition candidate has the following characteristics: operates in a growing industry, has proprietary products and/or processes, has a well-defined and established market position, has a good reputation, is involved in very little, if any, litigation, is open to the idea of being acquired by another firm, is positioned to readily obtain key third-party consent to an acquisition, and is located in a geographic area that is easily accessible from the acquiring firm's headquarters location.
8. Licensing is the granting of permission by one company to another company to use a specific form of its intellectual property under clearly defined conditions. Virtually any intellectual property a company owns can be licensed to a third party. Licensing can be a very effective way of earning income, particularly for intellectual property-rich firms, such as software and biotech companies.
9. A strategic alliance is a partnership between two or more firms that is developed to achieve a specific objective or goal. Technological alliances involve cooperating in areas such as research and development, engineering, and manufacturing. Marketing alliances typically match one firm with a partner's distribution system that is attractive to the company trying to increase sales of its products or services.
10. A joint venture is an entity that is created when two or more firms pool a portion of their resources to create a separate, jointly owned organization. In a scale joint venture, the partners collaborate at a single point in the value chain to gain economies of scale in production or distribution by combining their expertise. In a link joint venture, the position of the parties is not symmetrical and the objectives of the partners may diverge.

KEY TERMS

- | | | |
|---|--|--|
| acquirer, 474 | licensing, 477 | organic growth, 463 |
| acquisition, 474 | licensing agreement, 478 | outsourcing, 468 |
| external growth strategies, 472 | licensor, 478 | product line extension
strategy, 468 |
| geographic expansion, 469 | link joint venture, 482 | scale joint venture, 482 |
| improving an existing product
or service, 467 | marketing alliances, 479 | spin-ins, 482 |
| internal growth strategies, 463 | market penetration
strategy, 467 | spin-outs, 482 |
| international new
ventures, 470 | merchandise and character
licensing, 478 | strategic alliance, 479 |
| joint venture, 482 | merger, 474 | target, 474 |
| licensee, 478 | new product development, 464 | technological alliances, 479 |
| | | technology licensing, 478 |

REVIEW QUESTIONS

1. Describe the difference between an internal and an external growth strategy. Provide examples of each strategy and how each one contributes to firm growth.
2. Describe the keys to effective new product and service development.
3. Describe some of the common reasons new products fail.
4. What is a market penetration strategy? Provide an example of a market penetration strategy, and describe how using it effectively might increase a firm's sales.
5. What is a product line extension strategy? Provide an example of a product line extension strategy, and describe how its effective use might increase a firm's sales.
6. What is a geographic expansion strategy, and what are the keys to implementing a successful geographic expansion strategy for an entrepreneurial firm?
7. What is an international new venture? Explain why it might be to the benefit of an entrepreneurial start-up to position itself as an international new venture from the outset.

8. What are the six foreign-market entry strategies? Briefly describe each strategy.
9. What are several rules of thumb to follow for selling products overseas?
10. Describe the difference between a merger and an acquisition. In what ways can acquisitions help firms fill their needs?
11. What are the characteristics of a promising acquisition candidate?
12. What is the difference between a licensor and a licensee?
13. What does the term *licensing* mean? How can licensing be used to increase a firm's revenues?
14. Describe the purpose of a licensing agreement. In a licensing agreement, which party is the licensor, and which is the licensee?
15. Describe the difference between technology licensing and merchandise and character licensing. Provide examples of both types of licensing and how they can increase a firm's sales.
16. Over the past several years, why have strategic alliances and joint ventures become increasingly prevalent growth strategies? Make your answer as thoughtful and as thorough as possible.
17. Describe the difference between technological alliances and market alliances. Provide examples of both types of alliances and how they can increase a firm's sales.
18. What is a joint venture?
19. How does a joint venture differ from a strategic alliance?
20. Describe the difference between a scale joint venture and a link joint venture. Provide examples of both types of joint ventures and how their effective use can increase a firm's sales.

APPLICATION QUESTIONS

1. Spend some time studying thredUP, the focus of the "You Be the VC 14.2" feature. Is it more likely that thredUP will grow through internal or external growth strategies? Provide suggestions of internal growth strategies and external growth strategies that make sense for thredUP.
2. Reacquaint yourself with Proactiv, the subject of Case 11.2. Proactiv has relied almost exclusively on internal or organic growth since it launched in the late 1990s. Do you think Proactiv's approach to growth has been appropriate? Has the company erred by not being more adventurous in its use of the various growth strategies?
3. Jessica Martin, a classmate of yours, just returned from an entrepreneurship boot camp, which was sponsored by her university's technology incubator and consisted of three days of intense focus on how to successfully launch a firm. You overheard Jessica telling another classmate that the boot camp was extremely helpful and she's already signed up for another three-day boot camp that will focus on how to successfully grow a firm. The classmate looked at Jessica and said, "How in the world can you spend three days taking about how to successfully grow a firm?" Jessica opened her notebook and showed the classmate the 10-item agenda for the upcoming three-day boot camp. What do you think the 10 items consist of? (Consider the material in Chapter 13 and this chapter in formulating your answer.)
4. Think of a company that you're familiar with that has grown via a product line extension strategy. Provide an overview of the company and how it rolled out its product line extension strategy.
5. Spend some time studying Chipotle, the popular Mexican food restaurant chain. Identify the growth strategies Chipotle has utilized. Comment on Chipotle's overall approach to growth and any growth-related challenges that you think Chipotle has today.
6. Zynga is a social network game developer that develops browser-based games that work both stand-alone and as application widgets on social networking sites like Facebook and MySpace. What are the pluses and minuses of Zynga's approach to launching games that rely on another company's platform (i.e., Facebook and MySpace) to reach its intended audience? Is Zynga growing via internal, external, or hybrid forms of growth?
7. Refer to Joby Energy, the subject of the "You Be the VC 10.1" feature. Which of the foreign market entry strategies described in Table 14.4 make sense for Joby Energy? If you were the founder of Joby Energy, which strategy would you pursue first if you decided to grow via international expansion?
8. Cisco Systems, Microsoft, and IBM are consistently the largest acquirers of small,

technology-based entrepreneurial firms. Why would Cisco Systems, Microsoft, and IBM, which each employ hundreds of product development specialists and engineers, buy other firms to acquire technology and add to their product lines, rather than developing the technology and new products in-house?

9. Google reportedly offered to buy Groupon for \$5 billion to \$6 billion in November 2010—an offer that Groupon turned down. Why do you think Google wanted to acquire Groupon, and why do you think Groupon turned Google down?
10. Brian Brunner is an entrepreneur who has invented several devices that are used in the telecommunications industry. He has patented the devices and manufactures them in a job shop in Oklahoma City. Brian sells the devices directly to AT&T and Verizon. Last week, Brian got a certified letter in the mail from Nokia, indicating that firm's interest in licensing the technology that is represented in one of his devices. Brian doesn't know anything about licensing and has turned to you for help. What would you tell Brian about licensing, and how would you suggest that he respond to Nokia's letter?
11. A friend of yours owns a chain of 25 fitness centers in Florida and Georgia. The fitness centers cater primarily to young professionals, ages 21 to 40. Your friend is worried because his centers have declined in terms of overall membership. Your friend told you that he's interested in pursuing strategic alliances to rev up the growth of his centers but is having trouble thinking about the types of companies he can partner with. Provide your friend with some suggestions.
12. Review the "You Be the VC" features for Chapters 10 through 14. Which of the companies featured is most likely to own intellectual property that other companies will want to license? Explain your answer.
13. Reacquaint yourself with Dry Soda, the focus of Case 9.1. Suppose the company hired you to investigate how licensing, strategic alliances, and joint ventures could spur its growth. How would you approach the investigation? Are the licensing, strategic alliances, and joint venture opportunities limited or plentiful? What types of deals do you think would be appropriate for Dry Soda?
14. Study the popular social networking site LinkedIn. What growth strategies has the company employed? Make recommendations for appropriate growth strategies for the future.
15. Which of the growth strategies discussed in the chapter are the most risky? Which are the least risky? What role should risk play in a company's decision to pursue a particular growth strategy?

YOU BE THE VC 14.1

Company: Cityscape Farms

Web: www.cityscapefarms.com

Twitter: [CityscapeFarms](#)

Facebook: [Cityscape Farms](#)

Business Idea: Create urban greenhouse systems for year-round production of sustainable and local fresh food.

Pitch: Food travels 1,500 miles on average in the United States to get to consumers. At the same time, global demand for food is increasing. By 2050, the earth's population will grow to nine billion people (compared to roughly seven billion today). That steep increase in population requires the development of new methods of farming in order to feed our planet's inhabitants. Concurrently, traditional methods of farming, which rely largely on petroleum to fuel farm vehicles and for fertilizers and pesticides, are coming under increased scrutiny. Petroleum is a nonrenewable resource. In addition, a growing number of people prefer organic food, which is largely grown without the use of petroleum-based

chemicals. Modern agriculture also uses 70 percent of the world's fresh water withdrawals, is the largest source of water pollution, and is the largest consumer of land.

Cityscape Farms offers an alternative. Instead of focusing on the countryside, where food must be trucked to processors and ultimately consumers, the company is focused on cities, and is building greenhouses on rooftops and in vacant lots. Cityscape's approach utilizes aquaponics, which is a combination of aquaculture (fish cultivation) and hydroponics (soil-less farming), where fish and plants are grown in a symbiotic system. Each greenhouse includes a fish tank. Water from the tank, which is enriched by the fish waste, flows through a filter and a pump, and is then distributed into growing trays, where fruits and vegetables are grown. The water

is then returned to the tank. It's a closed-loop organic and pesticide-free system. It also requires a relatively low water usage. Fruits and vegetables can normally be grown via aquaponics for one-tenth the amount of water required of traditional farming. Once the system is operable, the only new water entered into the system is to replace that lost by evaporation. No chemical fertilizers are used. Instead, as part of the filtering process, a bacterium is introduced, which turns the fish waste in the water into nitrates that in turn fertilize the plants. The plants filter out the nitrates and return clean water to the tank. As an added benefit, there are advantages to integrating a farm into a building. It reduces the need for supplemental lighting and lowers the cost of cooling a structure. All of these benefits are available with extant technology.

The reason Cityscape Farms is focusing its efforts on cities is because that's where the people are. Presently, just less than 50 percent of the world's population (3.3 billion people) lives in cities, a trend that is expected to accelerate. By producing food in cities, Cityscape

Farms not only reduces the need to transport food long distances to reach consumers, but can deliver to consumers safer, fresher, and tastier food products.

Cityscape Farms is currently preparing to go to market with its solution. According to Wikipedia, a sprinkling of rooftop hydroponic greenhouse can be found around the world, including at academic centers in the United States (Washington University and Barnard College, among others), on a hospital (Changi) in Singapore, in Holland, in India, and in parts of the developing world. Individuals having mind-sets that place high value on environmentally friendly actions such as those promoted by Cityscape will be critical to the firm's success.

Q&A: Based on the material covered in this chapter, what questions would you ask the firm's founders before making your funding decision? What answers would satisfy you?

Decision: If you had to make your decision on just the information provided in the pitch and on the company's Web site, would you fund this company? Why or why not?

YOU BE THE VC 14.2

Company: thredUP

Web: www.thredup.com

Twitter: thredUP

Facebook: thredUP

Business Idea: Provide a convenient online platform for the parents of growing children to exchange the clothes their children grow out of for clothes their children need.

Pitch: The average kid grows out of a set of clothes every three to six months. In the United States, evidence suggests that by the age of 17, kids have outgrown over 1,300 items and parents have spent nearly \$20,000 on their clothes. There are existing ways for parents to sell or exchange outgrown clothes, including swap parties, eBay, and consignment shops. But these are inconvenient solutions, and often yield very little money or results for the effort involved. The problem is particularly acute for the parents of babies and young children. As adorable as kids' clothes are there's no escaping the fact that healthy young children grow out of clothing quickly.

If you're a parent with a baby or young child, or know someone who is, you're probably nodding your head in agreement. There's just not a good solution for selling or exchanging used clothing to acquire new clothing—until now. thredUP is a Web site that allows parents to exchange boxes of lightly worn clothes that no longer fit their kids for similar clothes from like-minded families. Here's how it works. Users can browse thredUP for boxes of 10 to 18 tops, bottoms, or a mix of both, and search by gender, size, and season. Once a selection is made, the user pays \$5 plus shipping, and the box is on its way.

The user is then obligated to assemble a similar quantity of clothing to put into a box and inform thredUP of what's in the box. thredUP will then list that box on its Web site. When someone chooses their box, the user will be sent a link to the USPS Web site, where they'll be provided access to a free shipping box, a printable mailing label, and schedule a pick up for the box. This process can be repeated over and over again, as a user's child grows and needs new clothing. Added benefits to the service are that it helps families save time and money and is environmentally friendly in that, currently, over 20 billion pounds of clothing and textiles enter U.S. landfills every year. By helping families share rather than prematurely discard used clothes, thredUP can help reduce that number.

thredUP makes money in two ways: (1) the \$5 transaction fee for each swap and (2) via premium memberships, which sell for \$4.99 per month or \$29.99 per year. A premium membership provides subscribers specific information about what's in the boxes they're considering.

Q&A: Based on the material covered in this chapter, what questions would you ask the firm's founders before making your funding decision? What answers would satisfy you?

Decision: If you had to make your decision on just the information provided in the pitch and on the company's Web site, would you fund this company? Why or why not?

CASE 14.1

How Mint.com Went from Launch to a \$170 Million Acquisition in 24 Months

Web: www.mint.com

Twitter: [mint.com](https://twitter.com/mint.com)

Facebook: [Mint.com](https://www.facebook.com/Mint.com)

Bruce R. Barringer, *Oklahoma State University*

R. Duane Ireland, *Texas A&M University*

Introduction

How did Mint.com go from launch to a \$170 million acquisition in 24 months? The answer isn't as spectacular as you might think. Using a football metaphor, Mint.com did it more through blocking and tackling than through big plays. Mint.com's story is one of how a start-up that solves a real problem, and executes very well, can overcome obstacles and win the support of others. It's also a story of how a small company can take on a big rival, and by positioning itself for the future rather than the past, can motivate the rival to acquire it rather than trying to put it out of business through aggressive competition. Let's see how all of this took place.

Aaron Patzer

Aaron Patzer started Mint.com when he was just 25. After earning degrees from Duke and Princeton, he took a job with Nascentric, a Silicon Valley start-up. During this time, he was managing his personal finances with Quicken and Microsoft Money, and became increasingly frustrated with his experiences. He asked around and found others who were aggravated with these products and personal finance in general. He started thinking about how to build a product that would not only be an improvement to Quicken and Microsoft Money, but would make the entire process of managing money more efficient and potentially rewarding.

Patzer struggled with whether to act on his instincts and eventually decided to move forward. His thought process during this period is best illustrated through his own words. In an interview with Carson McComas, the creator of WorkHappy.net, a popular blog, Patzer reflected on how he made the decision to quit his job and focus on Mint.com full-time:

I began to think about the business nights and weekends. But it's hard to find time when you've got a full time (and very demanding job). One day I said to myself, "If you give it 100% and fail, I can live with that. But I can't live with going half-way,

part-time." So on March 1, [2006], I quit my job and began working on Mint. The first few months were tough, and I basically oscillated day to day between thinking "This is the greatest idea ever" and "This will never work." Who am I to take on Intuit (the maker of Quicken) and Microsoft? If this was a good idea, someone would have done it before.

Patzer went on to say that the thing that gave him the most inner confidence was that he knew he was exceptionally good at one thing: algorithms—the key to computer programming. He also knew he was persistent and extremely passionate about his idea.

Prelaunch Stage—March 2006 until September 2007

Patzer worked 14 to 16 hours a day, 6½ days a week, from March 2006 to the fall of the same year banging out the early prototype of Mint.com. Needing money to make key hires, improve on Mint.com's consumer interface, and buy servers, Patzer approached several investors. None bit. The problem was the way Mint.com was set up. Quicken and Microsoft Money were software products that people bought and then installed on their computers. Mint.com was an online dashboard. When you signed up for a Mint.com account, it asked you to provide all of your bank, credit card, and investment account information, user IDs, and passwords. Mint.com, through a partnership with a financial services firm, could then "scrape" the sites of your bank and credit card companies, and provide a real-time update of your financial information. It could also e-mail you due date reminders, low-balance alerts, unusual activity alerts, and the like. A user could log onto his or her Mint.com account at any time and see all of his or her account information on a single screen. This is the better experience that Patzer was looking for. The average American has 11 separate bank, credit card, loan, and investment accounts. Patzer's idea was that having a single place where all the account information is displayed and updated on a consistent basis would be a superior customer experience.

(continued)

The investors all said the same thing. People will not trust a start-up with their account information—let alone their user IDs and passwords. Patzer persisted. In September 2006 he found an investor that believed in his vision and was able to persuade a venture capital firm to go along. Mint.com's first round of funding was \$750,000, \$325,000 from First Round Capital and \$425,000 from other investors.

Two things helped Mint.com raise more money. The first was carefully explaining the security aspects of its service, not only to potential investors but to literally anyone who would listen. Mint.com is a read-only system. What this means is that even if someone broke into its system, they couldn't steal someone's money or even move it around. They could just look at account balances and how people spent their money. In addition, Mint.com had bank-level security in place from the outset. It had the same level of encryption and bank-end protections that a bank did. Mint.com also did something very smart. It turned the security issue on its head. It argued that rather than putting people at risk, it actually protected people's finances. By allowing its customers to view all of their financial information at a single site, customers could quickly log on to their account and scan their financial information to see if anything seemed out of place. In addition, it sent its customers low-balance and unusual activity alerts.

The second thing that helped Mint.com raise additional money is that it won TechCrunch40, a high-profile business plan competition, in fall 2007. TechCrunch40, which was later named TechCrunch50, was a prestigious business plan competition that ran from 2007 to 2009. Looking back, Patzer says that the seven minutes he had to pitch Mint.com at the competition was the seven most important minutes of his life. The conference was an enormous platform. It was well attended by press, investors, and large companies looking for strategic partners. Over 700 companies applied for the 2007 competition. The top 40 were chosen to present. Winning gave Mint.com the outside validation it needed to move beyond the small group of investors that believed in it to a larger group that was now willing to give it a second look. It also explains Mint.com's fast start with users. The enormous press generated by the TechCrunch40 win placed Mint.com's name in front of an untold number of people in a very positive manner.

During this time, Mint.com was intently focused on execution. One of the rules of TechCrunch40 was that the competitors had to be at the prelaunch stage, so Mint.com was still in a testing mode. Patzer made his first key hires. His first hire was Jason Putorti, the designer who had built apple.com, to plan and design Mint.com's customer interface. According to Patzer, Putorti cared about every pixel, and it showed in the beauty and functionality of the site. Putorti brought people into Mint.com offices, literally right off the street, to test the site and see where the rough spots were. He brought in young people, old people, men, women—as diverse of a group as he could find. Patzer's third hire was David Michaels, VP of Engineering. Michaels had 15 years' experience in security, including financial Web services.

Two Years as an Independent Company—September 2007 until September 2009

Mint.com formally launched in September 2007, just after TechCrunch40. The skeptics were wrong. In its first four months it signed up 100,000 people, all of whom entered their financial information, including account numbers, user IDs, and passwords, into Mint.com. Mint.com didn't have a single security breach. Its numbers accelerated through the end of 2007 and into 2008. Mint.com is free to the user. Its revenue model is to make referrals to its users, and then collect affiliate fees when its users follow through. For example, if Mint.com sees that a specific user is paying 16.9 percent interest on a credit card, and the user is financially sound, it will suggest a lower-interest rate credit card. If the user takes the offer, Mint.com makes a small commission.

Buoyed by its TechCrunch40 win and steady growth, Mint.com raised \$31 million through several venture capital rounds from September 2007 until mid-2009. The purpose of the capital was to build out the company's infrastructure to accommodate its growth. During this period, Patzer remained Mint.com's primary spokesperson and evangelist. He would accept almost any opportunity to talk about Mint.com and its story. As a result, Mint.com's growth was paralleled by persistent public relations efforts on the part of the company to keep itself in the news and on the minds of journalists and bloggers.

In late 2009, just prior to the Intuit acquisition, Mint.com had 1.5 million users tracking nearly \$50 billion in assets. It was also widely considered to be one of the up-and-coming Web 2.0 companies.

The Intuit Acquisition—September 2009

Intuit acquired Mint.com in September 2009, just 24 months after Mint.com launched. That's a quick run-up to an acquisition. Venture capitalists, for example, typically have a three- to five-year investment horizon, meaning they'd like to see the companies they invest in get acquired or launch an IPO sometime during that period. Most of Mint.com investors monetized their investment in 24 months or less.

For its part, Intuit was a strong company in 2009, with over \$1.1 billion in sales and several marquee products, including Quicken, Quick Books, and TurboTax. But it was also a boxed software company, struggling to gain a footing on the Web. Its fear was that Web-based services like Mint.com represented the future, while boxed software products like Quicken represented the past. In June 2009, Microsoft contributed to this fear by discontinuing sales of Microsoft Money, its boxed financial software product. In the end, many analysts believe it was a no-brainer for Intuit to buy Mint.com. It gave Intuit a quick entry into the Web-based side of personal financial management.

The acquisition was also good timing for Mint.com. Patzer and his team were interested in continuing to accelerate Mint.com's growth. Intuit had the financial resources to do that, and by being part of a large company, Patzer could focus solely on product

development rather than raising funds. One of the conditions of the deal was that Patzer was able to continue to operate Mint.com in an autonomous manner. He was also named general manager of Intuit's personal finance division. As an added bonus for Intuit, Patzer's charge was not only to continue to build Mint.com, but to instill some of its Web savvy into other Intuit products.

Discussion Questions

1. If you had been a venture capitalist at the time Patzer was originally pitching Mint.com, would you have had the same concerns as the venture capitalists at that time did? Why do you think the venture capitalists weren't more forward thinking? Why do you think Patzer didn't see the initial reaction to Mint.com as reason to either give up or to significantly modify his service?
2. Evaluate how effectively Mint.com prepared for its launch and early growth. What specific steps did the company take to prepare for and stimulate its early growth?
3. Do you think Intuit's acquisition of Mint.com was a win for both Intuit and Mint.com? In what ways does an acquisition by a large firm potentially accelerate the growth of a small firm, beyond what the small firm could have accomplished on its own?
4. Why do you think Intuit didn't create an online site similar to Mint.com, rather than spending \$170 million to acquire Mint.com?

Application Questions

1. What are the inherent challenges involved when a large firm acquires a small firm, particularly if the core management team from the small firm joins the large firm? Which of these challenges do you think will be particularly difficult for Patzer and his team?
2. Do some research on Intuit's acquisition of Mint.com, and report on the current status of the acquisition, in terms of successes and disappointments. In your opinion, has the acquisition been a good thing for Mint.com and its users? Explain your answer.

Sources: Mint.com Web site, www.mint.com (accessed April 8, 2011); Carson McComas, "Interview with Aaron Patzer, founder of Mint.com," *Workhappy.net*, www.workhappy.net/2008/02/interview-wit-1.html (accessed April 8, 2011, originally posted on February 19, 2008) Used with permission of Mint.com and Aaron Patzer; Olaf De Senerpont Domis, "Intuit to Buy Mint.com," *LexisNexis Academic*, www.lexisnexis.com/hottopics/Inacademic/ (accessed April 8, 2011, originally posted on September 14, 2009).

CASE 14.2

Will Groupon Maintain Its Sizzling Pace of Growth?

Web: www.groupon.com

Twitter: www.grouponOKC (varies by city)

Facebook: *Groupon*

Bruce R. Barringer, *Oklahoma State University*

R. Duane Ireland, *Texas A&M University*

Introduction

Groupon is a deal-of-the-day Web site that is located in major geographic markets across the world. Launched in October 2008 by Andrew Mason, Groupon has been characterized as one of the fastest-growing companies of all time. It was first offered in Chicago, followed soon thereafter by Boston, New York City, and Toronto. Since then its growth has been spectacular. It is now in over 550 cities, has 44 million subscribers and 3,100 employees. According to an August 2010 feature in *Forbes*, Groupon topped \$500 million in revenues in 2010 and is on pace to become the fastest company in history to reach \$1 billion in sales.

Groupon's name is a combination of the words *group* and *coupon*. Most subscribers see Groupon as a fun way to shop and learn about businesses that

previously were unknown to them. For businesses, Groupon is largely a customer acquisition tool. It's becoming increasingly difficult for brick-and-mortar stores and organizations to drive traffic to their locations. As a result, they're looking for ways to increase foot traffic and jump-start their sales.

How It Works

Groupon offers one deal a day in each of the markets it serves. If a certain number of people sign up within a specified time, the deal is "on." If not enough people sign up, the deal is "off" and no one is charged. The day this case was written the Groupon deal in Oklahoma City, Oklahoma, was \$5 for \$10 worth of breakfast and lunch fare at Ground Floor Café, a restaurant in downtown Oklahoma City. A total of

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50 people needed to take the deal for it to be “on.” By 7:55 A.M. the day the deal was posted, the 50 person minimum had been met. By noon, 229 people had taken the deal and by 5:00 P.M. the number was 337. To participate, an individual must be a Groupon subscriber, which is free. Once a subscriber takes a deal, a reservation is made in his or her name, and the subscriber’s credit card is charged once the deal is “on.” A voucher is then delivered via e-mail to confirm the purchase. The voucher is taken to the merchant offering the deal to redeem the purchase. There is usually an expiration date on the voucher—6 to 12 months is common. A 6- to 12-month time frame gives the purchaser a comfortable amount of time to use the voucher, and spreads out the number of people coming into a business to redeem the voucher.

Once you become a Groupon subscriber, you sign up for one or more cities, and then receive the daily deal for each city via e-mail, Twitter, or Facebook. Groupon makes money by keeping approximately half the money the customer pays for a deal. So, if an \$80 massage is offered for \$40, then Groupon and the retailer spit the \$40. Groupon’s primary target market is 18- to 34-year-old urban females.

A visual depiction of Groupon’s business model, from both the business side and subscriber side, is shown below.

Groupon’s Pitch to Merchants

Groupon’s pitch to merchants is that it’s a customer acquisition tool. The hope is that the people who take the deal will not only redeem their coupon, but will spend more money when they’re in the store and will become repeat customers. Groupon works best for service-based businesses that have high fixed costs and low variable costs, making the cost of offering a

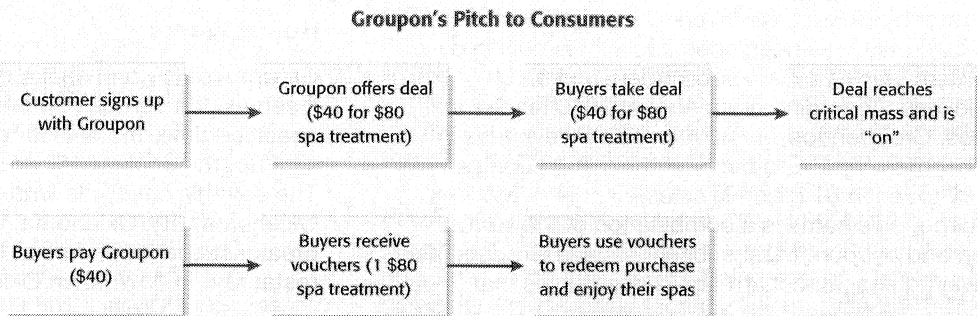
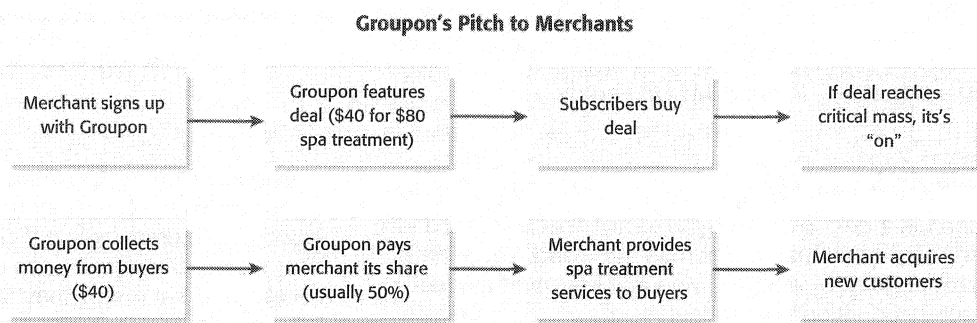
deep discount palatable. Groupon’s five most common groups of offerings include restaurants and cafés, food, salon, make-up and spa, and tickets.

Groupon is particularly attractive to small businesses that have trouble getting the word out about their offerings and don’t have a large advertising budget. A small yoga studio is an example of such a business. Prior to Groupon, the studio’s options for increasing awareness would have been newspaper, radio, online, and via social networks. The disadvantage of these forms of advertising, with the exception of social networks, is that they must be paid for up front. Groupon is free. The yoga studio doesn’t pay Groupon to set up the campaign. It simply splits with Group on the revenue that’s generated. Typically, a business like a yoga studio can take on additional customers without increasing its fixed costs. The only additional costs incurred to service the business brought in by Groupon may be to hire additional instructors to offer more classes.

Not all Groupon campaigns have worked out, and the company has come under increasing criticism. For example, a successful deal could temporarily swamp a small business with too many customers, risking the possibility that customers won’t be satisfied or that the business will not be able to satisfy the demand. For example, one coffee shop in Portland, Oregon, signed up with Groupon in mid-2010, and offered \$13 worth of products for \$6. Nearly 1,000 people bought the deal the day it was advertised, swamping the small shop for three months. In a blog post, the owner said that the volume of sales coupled with the deep discount threatened the survival of the business. Similarly, U.S. Toy Company’s store in Kansas City offered \$20 worth of merchandise for \$10 in July 2010, hoping to spur sales and acquire new customers. About 2,800 people took the deal. The campaign was a disappointment. According to the company, about 90 percent of the Groupon takers were already customers, and the

Groupon’s Business Model

Example: \$40 for an \$80 Spa Treatment



majority of them came into the store only to redeem their \$20 coupon. The company says it lost money on about three-quarters of its Groupon-related sales. For its part, Groupon says that its overall satisfaction level is high, and 97 percent of businesses that run Groupon campaigns ask to be featured again.

Groupon's Growth Strategy

Groupon has grown organically and via acquisitions. Its organic growth has been generated largely by signing up new subscribers and expanding to new cities. It's also been a busy acquirer. Groupon made at least 10 acquisitions in 2010 and early 2011, including European deal-of-the-day site MyCityDeal, Indian deal-of-the-day site SoSasta.com, mobile technology

company Mob.ly, and Pelago, the parent company of check-in-service site Whrrl.

Groupon has fueled its growth through several rounds of substantial funding. In early 2011, it raised \$950 million from a group of investors. In early 2010, it raised \$135 million. Observers speculate that Groupon has used the money to expand its sales force, scale its back-end operations, make acquisitions, and prepare for future growth. It's rumored to be anticipating an IPO in the foreseeable future.

Future Growth Prospects and Challenges Ahead

Looking forward, Groupon has both possibilities for additional growth and challenges that it must deal with. Likely possibilities for future growth are shown next.

Groupon's Future Growth Possibilities

Internal Growth Possibilities

1. Enroll new subscribers via viral marketing, paid advertising, and social media.
2. Expand to new domestic cities.
3. Expand to new international markets.
4. Develop new products, such as a separate Groupon-owned site that isn't tied to specific geographic areas, but focused on products, such as high-end luxury goods.
5. Increase participation of current subscribers and enroll new subscribers by making it more convenient to interact with Groupon via mobile platforms.

External Growth Possibilities

1. Acquire deal-of-the-day sites in the United States and abroad, and re-brand them with the Groupon brand.
2. Acquire deal-of-the-day sites in the United States and abroad and allow them to operate autonomously.
3. Enter into strategic alliances with major retailers to provide back-end functionality for deal-of-the-day offerings they make to their customers. For example, a retailer like Best Buy could offer daily deals, which must be redeemed at a Best Buy store. The idea would be to drive foot traffic to stores.

The viability of each of these possibilities for growth hinges on two factors: (1) whether they're in Groupon's best-interest to pursue and (2) whether they're within Groupon's capabilities. For instance, in regard to the former, Groupon has resisted deal-of-the-day initiatives that focus on products rather than services, and are national rather than local in scope. There were multiple deal-of-the-day sites that focused on products, such as electronics and jewelry, that preceded Groupon and failed. Groupon has built its success on offering local deals for service providers. In regard to the later, observers wonder how large Groupon can grow before it needs to pause to allow its leadership capacity to catch up with its growth.

Groupon also faces challenges with the primary one being the number of copycat sites that are being launched and are trying to erode the firm's market share. Its most direct competitor is LivingSocial, which has a business model that's very similar to Groupon's. Other sites are springing up, both domestically and internationally. In China, for example, there are now more than 50 Groupon-type daily deal sites. It's unclear how Groupon will deal with increasing competition.

Groupon also runs the risk that negative publicity will deter business participation. Reports about merchants who have lost money running Groupon campaigns may cause some prospects to pause. In addition, it runs the risk of subscriber fatigue. By appearing in its subscribers e-mail boxes every day, some subscribers may tire of the drumbeat of Groupon deals and eventually drop the service.

Discussion Questions

1. Evaluate Groupon's strategies for growth. Do you think Groupon has done a good job in terms of identifying the most fruitful avenues for growth, or do you think Groupon should have been more creative in its growth strategies? Make a list of things that Groupon *hasn't done* that you think have indirectly contributed to its growth.
2. How does a company go about getting its business featured on Groupon?
3. Of the current challenges facing Groupon, which one do you think is the most threatening? If you were

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the CEO of Groupon, how would you address this challenge?

4. Refer to the table shown in this case that lists Groupon's internal growth possibilities and its external growth possibilities. Of the eight growth possibilities, rank them 1 to 8 in terms of the order of likelihood that Groupon will utilize that possibility as part of its future growth strategy. Explain the rationale for your rankings.

Application Questions

1. Some observers have questioned whether Groupon's pace of growth is sustainable. Briefly make the argument for and the argument against the sustainability of Groupon's growth.

2. Sign up for Groupon in a city of your choice (it's free). Follow the Groupon deals for at least a week. Record your observations. Do you think Groupon's business model and its basic approach are sound? What is it that you liked and didn't like during the week that you followed Groupon? Do you think Groupon will remain attractive to businesses and consumers?

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