

12 CAUSES OF FAILURE OF A SMALL COMPANY

2005 Edition

Phyllis Verma and Tom Saftig

The More Things Change...

When P Wilson as the VP Sales and T Roland the CFO/COO joined Penryn Security two years ago, it was a promising early stage company with initial funding, a proven product, new products in the pipeline, an established distribution network and growing revenues. Two years later the Company had closed and Wilson and Roland were updating their resumes and looking for new career opportunities. What happened? Nothing that doesn't happen every day to small businesses across America.

Business in 2004-05 is different in many ways from years past; however, most of the reasons behind small company or startup failures remain the same. Regardless of the industry, small companies share a common set of issues that negatively impact a firm and cause it to flounder or fail. This article will pinpoint the issues – all based on actual experience.

For Penryn, things got rocky when egos and personal gain directed a series of bad business decisions. Wilson and Roland stuck it out as long as they could but eventually they saw the handwriting on the wall and elected to apply their expertise elsewhere.

Recent statistics indicate that professional investment firms (VC's and Private Equity or Angel Investors) may invest seed money in 1 company for every 10 that they seriously review. Of the 10 they review, they receive about 100 proposals. Once the investment has been made, 15-20% of the companies turn out to be dogs and fail, 40-70% survive but don't thrive and require additional funding, and 10-20% are successful, some fabulously. Here are 12 reasons why potentially great companies end up either on the scrap pile or surviving when they could have thrived.

1. WEAK MANAGEMENT TEAM

One of the biggest challenges facing a small, growing company is putting together a top management team with limited resources. You may have to use part-time help or equity incentives to attract the talent needed to move your small company forward. The trap is in hiring sub-par talent and then burning through your seed capital with sub-par results. If this happens, the "great" product or idea never has a chance.

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Take-away: It's far better to have quality part-time help than mediocre full-time help.

2. FOUNDER/CEO

Not all founders possess the management and leadership abilities of a Bill Gates. Generally, the founders of small firms - especially in the technology sector - possess technical and/or marketing creativity that they used to come up with the product or service that they are attempting to grow into a business.

Frequently, the founder is better suited to product enhancements or future product development than organizational development.

Take-away: It's crucial that company founders recognize their value to their company. Small companies without good leadership will fail.

3. WEAK BOARD OF DIRECTORS

Passive directors on the board are a thing of the past. Each board member needs to bring unique and critical experience and skill sets that will guide and help the company to grow. It's common to have one inside leader on the board, but it's not always necessary. It's common to have investor representation on the board but not always necessary. It's common to think that the small business needs "recognizable names" but not always necessary. It is necessary that the board member have a passion for the business, the confidence in the management team to run the company, and the motivation and experience to do the job.

Take-away: Strategic directors can bring many benefits: additional sales channels, credibility and financial contacts. A growing trend is for professional investors to request "advisory board seats" instead of regular board seats. This may allow them to contribute in a positive way, but it's unclear how they will be able to help in critical decision making.

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4. LACK OF A CLEAR PATH TO MARKET

Understanding the market position of the small company's product or service is crucial to its success. The competitive landscape, the value statement, the size of the market, the realistic penetration of the market, the focus required to achieve that penetration, the capital to gain exposure and successfully promote the product, and the talent to market and sell are all elements of a clear path to market. Without a clear path, the company will limp along and sell on an opportunistic basis, never reaching its potential.

Take-away: Developing a well thought out sales and marketing plan that includes all the key issues of pricing, promotion, distribution and product will allow the firm to maximize its exposure with the minimum financial requirements.

5. LACK OF FOCUS

When a small firm develops a product, the applications for that product are invariably large and diverse. The more prospects the firm approaches, the more uses are uncovered. The trap that many firms fall into is trying to attack multiple opportunities before establishing a beachhead in one industry or market. This lack of focus may cause the firm to expend its financial and operational resources without gaining the necessary traction to insure success.

Take-away: Staying focused doesn't mean being inflexible and blind to changing market conditions.

6. LACK OF STRATEGIC FINANCIAL PARTNERS

To be successful, most small businesses need some level of financial backing, but a financial partner must bring more to the table than just money. For example, the company may need a high-profile financial partner so it can get in the door and stay in the door of a large (possibly blue chip) distribution channel.

Large customers or distribution partners look to the small company's source of funding. They need to determine if it's worth risking doing business with a company that could go under and how that might undermine their own customers.

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Any decision driven by greed or power is doomed, and it couldn't be truer when seeking funding. Everyone has a story about the startup finally earning a term sheet for funding, holding out for a 'better' deal and then being surprised when the investor walks away. Then they have to spend months and maybe years looking for funding while the business flounders. While it may appear that a company has multiple investor possibilities, if it declines one, the other "financing competitors" may balk as the deal has gotten stale. Or they may just perceive the founders as greedy. Once again, make sure your decision-making motivations have integrity and are business oriented.

On the subject of investment, it's crucial that you ask for what is needed to execute your business plan and achieve success. If your company requires a \$3 million dollar investment, you should raise the full amount. Don't be satisfied with a portion of it, with a promise of more capital when needed. Any number of events can get in the way of an investor fulfilling that promise, and that forces you to divert attention while trying to raise the remaining capital.

Take-away: Understand what you need, and don't stop cultivating financing sources until the funds have cleared your company's bank account.

7. HIRING FAST AND FIRING SLOW

The characteristics that make an entrepreneur successful aren't the same characteristics that make for good business leadership. For example, entrepreneurs need to be creative, act without a great deal of structure, move quickly and alone, and push ahead without sensitivity to others. If it weren't for the entrepreneur, the business idea wouldn't be conceived or developed, but an entrepreneur is generally not a team player or business leader.

Investors are often the voice of reason in hiring. Experienced investors recognize key team members who will eventually contribute to the business failure. While investors aren't actively involved in hiring, they'll walk away if a cohesive team isn't in place.

Startups and small companies often hire family and friends because they think they 'owe' it to them. The fact that this is a business run using other people's money is overshadowed by an ego-centered conviction that they are hiring people they can work with. Nepotism is a sure sign of failure.

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Take-away: When searching for talented team players, use your trusted service providers of accountants, law firms, commercial real estate brokers, insurance agents and venture capitalists to seek out leads. Hire slow and fire fast.

8. PLACING MORE IMPORTANCE ON PATENTS THAN DEVELOPING A BRAND

There's no doubt that patent protection has value. Some large, well-capitalized companies have been able to enforce patent protection successfully. But small companies are often better served by building product name recognition in the market place through exposure and, most important, sales. A well-developed brand allows your company to be innovative on an ongoing basis, resulting in the ability to gain momentum and stay ahead of the competition.

Take-away: Patents are important, but only if you're prepared to defend them. Brand development is critical. You shouldn't rely on patent protection to defend your place in the market.

9. BUILD IT HERE SYNDROME

By nature, an entrepreneur wants to control the enterprise as it grows, but that may slow down the development process. Using outside development or manufacturing capabilities may be the only way to attain the speed required to meet market demands.

However, there is a correct way to outsource. You must have someone to guide the strategy. Depending on what business you're in, that might be a "project leader" or "CTO" or "in-house architect" or "in-house engineer." This person should be intimately involved with the product and understand exactly what needs to be done by the outside firm. The danger is that as soon as the initial specification is complete and your budget is used up, the next round of product enhancements or improvements may come at a very steep price.

Take-away: The "Cisco" model of outsourcing allows for fast growth with limited capital requirements. Just make sure that you have a project leader to guide the outsourced development or manufacturing project.

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10. WHY PARTNER? I CAN DO IT

This is related to the previous point but refers specifically to marketing. Small companies get branded very early as being “unstable” or “risky” and that often results in customers being reluctant to buy their products. Because your small company may lack sufficient resources to sustain itself in a downturn, a larger company may be reluctant to do business with you. By partnering with a large known entity, that reluctance will be mitigated, because the well-established firm can provide stability, market presence and distribution channels.

Or, you may be trying to attack a broad market that would require huge amounts of capital to develop a distribution channel to pursue the opportunity that will then be destined to failure.

There is a caveat to this strategy: just signing a “distribution agreement” with a major player in the industry doesn’t guarantee sales. Generally, it’s just the opposite. While you’re thinking that you signed an agreement and that the big company will distribute your product, the big company is usually only agreeing to allow you to integrate with its products and may not be committing to market or sell your product. You need to be careful that you don’t hurt yourself by spending too much time, energy and money trying to establish a relationship with a large “player” without a complete understanding as to what functions the partner will perform.

Take-away: Make sure you completely understand what the “player” is going to do and not do as part of the agreement.

11. THERE IS BAD INVESTMENT MONEY OUT THERE

No matter how much you need seed or growth capital, not all investment money is good. Be wary of investors, especially early angels, who put personally motivated demands on your company. For instance, they might want a senior job, a job for a family member or friend, a lucrative consulting contract, an undeserved board seat, complete control, or an unattractive supply or customer contract. By giving into one or more of these demands, you put yourself in a bad position when a larger, more credible investor comes along. Later investors often look for these kinds of skeletons in the closet and may become a reason not to invest.

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Take-away: A strategic investor should bring more to the table than just money. They should be able to provide sales or procurement relationships to help jump-start your company on its road to success.

12. NOT TAKING ADVANTAGE OF BEING SMALL

Growing companies will never again be in the fortunate position of being able to act and react swiftly. When an opportunity is recognized or an opening in the market manifests itself, you should mobilize and implement extremely quickly and use this strength. By the time the big competitor gets around to acting, you can already have a foothold in the marketplace. By not acting with speed, you run the risk of being just another struggling, under-capitalized, under-manned and under-resourced small company.

The action might be wrong. But you should have the ability to recognize and stop the project and related financial impact. Big companies take longer to stop a wrong decision, but they don't feel a significant impact because of their resource depth. Meanwhile, you'll have moved on. The important message is that your small company is, by definition, quick and nimble and should use this to its advantage. By the time a large company recognizes the market opportunity, your small company may be in position to be acquired or be a potential partner.

Take-away: Small means having the ability to be agile both in starting and stopping a direction when you're progressing down a new path to product launch and distribution development.

Stay Objective

Many of you will read this checklist and dismiss the failure cause as something that hasn't or won't happen in 'my' company. Be honest with yourself and look at your company objectively. Step back and see it from your customer's perspective, from your competitor's perspective, from your employee's perspective, from your board's perspective, and from your investor's perspective. Don't discount any perspective. Continuously examine and re-examine your company; that's what good business leaders do. Follow the rule of doing the right thing rather than doing things right.

Phyllis Verma is a business leader with experience in large Fortune100 companies as well as small companies. Her experience in establishing and

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positioning start-ups and early stage companies for investment provides real-life insight into business success/failure. She can be reached at pfverma@yahoo.com

Tom Saftig started his career with a Fortune 100 company and has been the CFO/COO and CEO for several successful and some unsuccessful start-ups and early stage companies. He can be reached at tsaftig@yahoo.com

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