HOW ENTREPRENEURS MAKE INVESTMENT DECISIONS

An unrisky business

By Professor Stuart Read (February, 2008)
Many people are surprised to learn that entrepreneurs are as risk averse as any average person on the street. What entrepreneurs have figured out are strategies to manage away the risk in a new venture. And one of the most useful strategies is gaining commitments from critical customers and partners as the basis for investing in an opportunity, rather than hoping for a pot of gold at the end of a big bet.

After a successful decade making industrial process equipment that treats liquid waste, such as the leachate from landfills to protect the water table, US businessman Bob Salter made a major change: he decided he wanted to produce drinking water products for individual users. He was attracted to an opportunity where people choose to buy the product rather than being forced to through environmental regulation. But along with the change came technology risk, new distribution channels, and customers he had yet to serve. How could he justify an uncertain bet with his company, Hydration Technologies Inc., when he already had a respectable business going with his existing industrial product?

**Potential customers lead to potential markets**

Salter was fortunate enough to already have a customer willing to make a financial commitment, which meant he was assured of demand before he ever created a product. And that customer was the US military. So rather than shopping for potential users to explore a possible opportunity, Salter was able to wait to “go” when a genuine customer seemed committed. The fact is that potential customers only lead to potential markets, and this uncertainty represents a big bet for a small company. On the other hand, committed customers define real markets with tangible revenue.

“Two interesting things happen when you force yourself to get customers on board early,” says Salter. “The first is that you might fail to get the commitments you want. But it’s better to know sooner rather than later, and for a lot less money. And second, you might be surprised by the committed customers you actually find, and be led into even more attractive opportunities. And surprised they were. Since HTi developed an individual user product, not only have other defense customers joined in but HTi has moved into disaster relief projects and baby formula filtration that prevents disease and saves lives around the world. But there is more to how entrepreneurs make investment decisions.
How do you know if a customer is committed?

The answer: When they invest their own time and money, ensuring they have a vested interest in creating a market with you. In HTi’s case, the US Army paid $600,000 for initial product development. Naturally they gained influence over what the final product would be, but Salter’s financial bet was dramatically reduced. And the Army’s initial purchase was approximately $7m. Customers, suppliers and partners that benefit from the value your new business can create are powerful sources of capital. They are more likely to offer favorable payment terms, cash up front for development and detailed purchase orders to borrow against, or may even sell your products and services with theirs by providing both capital and a market for your idea. They can effectively put you in business.

This article, written by Stuart Read and Robert Wiltbank, was first published in Business Life, British Airways’ in-flight magazine.

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