

FIFTH EDITION

ENTREPRENEURSHIP AND SMALL BUSINESS

START-UP, GROWTH AND MATURITY

PAUL BURNS

**Bonus
Cases**



Chapter 2 UK mergers and acquisitions policy



UK

Scaling technology companies

The UK has many high technology start-ups but all too often these are bought up as they get to a certain size by larger foreign firms eager to purchase their intellectual property. We saw this with *Astex Therapeutics*, purchased by the Japanese pharmaceutical company Otsuka (Case insight 2.5). There are many other examples. *Autonomy*, an enterprise software company, was purchased by the US company Hewlett-Packard in 2011 for \$11.7 billion. *Deepmind*, a company creating neural networks that are the basis of machine learning and AI, was purchased by the US company Google (now Alphabet) in 2014 for \$500 million. *Arm*, a company creating the ‘architecture’ on which the semiconductor is based (the logical computational models used in silicon chips), was purchased by the Japanese company Softbank in 2016 for \$32 billion. Because Arm was seen as just as important in their industry as Apple, Google or Huawei are in theirs, this was the highest price ever paid for a European high tech company.

It often makes good sense for big companies to do this. It can be cheaper than investing in R&D or they can use their global distribution and marketing channels to bring an innovation more quickly to market. Sometimes they simply want to squash competition or perhaps buy market share. Often it is part of a well thought through strategy of diversification creep that creates new industries or markets. For example, the US giant Amazon appears to have made over 100 acquisitions within the first 25 years of its existence (see Case insight 18.5). Whatever the logic on the part of the big company, the result is that ownership moves to another country and usually the headquarters goes with it – and that often means control. Ownership affects not only where the profits from these high tech businesses flow to, but often influences where further development and growth take place. Often the original UK company is absorbed or left to stagnate. Although sometimes when this happens employees from the original UK company decide to leave and start their own high tech business (see Case insight 14.1, Darktrace).

Autonomy became the subject of a lawsuit before parts were sold-off to Micro Focus in 2017. *Deepmind* has been absorbed into Alphabet and its technology used in other applications. *Arm* is still based in Cambridge but does not seem to have developed and grown under Softbank ownership. It continues to license its IP to other companies such as Intel, Apple and Huawei for them to customise to their needs, taking royalties for the IP. However, like so many of these acquisitions, in 2020 the company was sold-off again for £31 billion, this time to Nvidia, a US company that designs graphics processing chips primarily for the gaming industry. But the fear is that Nvidia will then withdraw Arm’s licencing agreements with Nvidia’s competitors, notably Intel and Huawei, and take the rump of *Arm* to the USA (Will Hutton, *The Observer*, 9 August 2020). This would mean the end of Arm’s independence – crucial to its business model of selling its IP to other chip designers and manufacturers – and an end to Arm’s strategic importance. *Arm’s* founder,

Hermann Hauser, described the sale as a 'disaster' saying that, as a subsidiary of Nvidia, *Arm* would 'wither on the vine'.

The UK may have more than its share of high tech start-ups but not enough turn into 'unicorns' and go on to be the big companies of tomorrow. Ownership and control of these businesses are fundamental issues that affect both individual and national wealth, creating a tension between private and public good. Companies quoted on stock markets can be particularly vulnerable to takeovers, especially in the UK since it does not allow founder shareholders to have differential voting rights as in the US and Canada (see Chapter 18). 'Anchor' institutional or government shareholders (e.g. sovereign wealth funds) are one way to secure ownership and control, but at what cost to the 'free market'?

Questions:

1. Why are ownership and control of a technology company important?
2. What are the tensions between private and government ownership and control? Can they be resolved?
3. Should a government intervene in the purchase of technologically and strategically important companies like *Arm*? If so how (e.g. prohibition, purchase etc.)?

Chapter 7 Monzo



Disruptive start-up

Monzo was founded in 2015 by Tom Blomfield, Jonas Huckestein, Jason Bates, Paul Rippon and Gary Dolman who met working at Starling Bank. It was one of the earliest of the new app-based 'challenger banks' (Starling Bank is a competitor) set up in the UK to disrupt the traditional high-street lenders; Barclays, HSB, Lloyds and RBS. Monzo's target customers are millennials who 'value convenience and technical innovation'. It originally operated through a smartphone app and prepaid debit card. Once it received its banking licence customers were offered free current accounts. Account holders can use their 'hot-coral' debit card and its app, which allows them to view transactions (and their location on a map), categorize them into 'pots' and freeze the card (if lost). In 2018 it launched interest-bearing 'savings pots'. Monzo places great value on transparency and its tone and use of language in communicating with customers. In 2020, the company announced the creation of two business bank accounts for sole traders and SMEs and a Monzo Plus account that paid 1 per cent interest on balances up to £1000. These gained over 50,000 customers within the first few month of launch.

Monzo is one of the UKs biggest fintech start-ups. In 2016, Monzo raised £1 million in 96 seconds via the crowdfunding platform Crowdcube (Case Insight 19.5). Between then and 2020 it went on to raise a further £371 million through crowdfunding and private equity funds. However, whilst the funding round in 2019 saw its value reach £2 billion, the subsequent round in 2020 saw it drop by 40% to £1.2 billion because of the economic effects of the coronavirus crisis. By this stage Monzo had 4.5 million customers generating revenues of over £67 million (2019/20) but was still making losses (£113.8 million in 2019/20). In 2020, Monzo appointed TS Anil as CEO, replacing Tom Blomfield (who remains President), citing the need for someone who had 'operated at scale', particularly with regard to complex banking regulation. TS Ani had previously worked at Visa and Standard and Chartered bank.



Access the Digital Links booklet to visit the company website and to watch Tom Blomfield giving a keynote speech on the future of Monzo.

Questions:

1. Why has Monzo been so successful in gaining investments?
2. What are the commercial and financial dangers it faces?
3. Why was TS Anil appointed CEO? Are there lessons from this?

Xtreme SnoBoards

Xtreme SnoBoards is a four-part case that covers pricing (case 1), constructing financial forecasts (case 3), evaluating those forecasts (case 3) and valuing the business (case 4). The company is fictitious.

Chapter 9 Xtreme SnoBoards (1)

Costs and pricing

Xtreme SnoBoards* was set up by two young snowboarding enthusiasts to manufacture a specialist snowboard that they have perfected after two years of development. The founders undertook a detailed costing exercise that showed that the average material costs for each board was £32 and the average variable factory overhead was £5 per board (consumables, electricity etc.). Total variable costs are therefore £37 per board. The founders intend to pay themselves £36,000 in the first year and to employ three factory workers at an annual cost of £70,000, giving a total wage bill of £106,000. The factory is leased at an annual cost of £14,000 and depreciation of equipment, spread over eight years, is calculated at £8,700.

The average costs of producing a board is shown below based on target production of 3,780 units:

Variable costs:

Direct materials	£32.00
Direct factory costs	<u>£ 5.00</u>
	£37.00

Fixed costs:

Direct labour	£106,000
Factory overhead – depreciation	£ 8,700
– factory lease	<u>£ 14,400</u>
	£129,100 ÷ 3,780 =
	<u>£34.15</u>

Total average cost of producing each board	<u>£71.15</u>
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The boards have been tested and used by professionals in competition and proved to be particularly responsive – so much so that a number of retailers have contacted the company to enquire about placing orders. There are three variations of board, designed for different conditions. The pair have researched their market and lined up two national retail chains and one overseas distributor who have placed advanced orders for the board at the price of £135 per board, net of delivery costs. These retail chains intend to sell the boards at about £400. The founders therefore estimate that each board should make a contribution of £98 towards the fixed costs of direct labour and factory overheads (a contribution margin of 72.6%: £98 divided by £135) and a

profit of £63.85 (a profit margin of 47.3%: £63.85 divided by £135), before other running costs for the business.

Questions:

- 1 How relevant are the costs of producing the board to the pricing decision?
- 2 Give some examples of what 'other running costs' are likely to be. Are they fixed or variable costs?
- 3 Based on these figures alone, what do you think of this business?
- 4 How can a shop justify setting a retail selling price of £400 for boards that cost them £135?

Chapter 15 Xtreme SnoBoards (2)

Building financial forecasts

In chapter 9 we looked at Xtreme SnoBoards, a company set up by two young snowboarding enthusiasts to manufacture a specialist snowboard that they have perfected after two years of development. The boards have been tested and used by professionals in competition and proved to be particularly responsive; so much so that a number of retailers have contacted the company to enquire about placing orders. There are three variations of board, designed for different conditions. The pair have researched their market and lined up two national retail chains and one overseas distributor who have placed advanced orders for the board at the price of £135 per board, net of delivery costs.

The initial sales estimates for the boards in the first year are shown below in Table 1. These figures represent total boards. 60% of these sales will go through the two major retailers and the overseas distributor. The sales estimates are highly seasonal, with sales mainly in the winter months. The founders intend to establish their small manufacturing facility in September and start manufacturing in October. These will be sent out to shops as demonstration models but, by agreement, they will not be invoiced as sales until January. They expect to have produced some 400 boards by then. These will be counted as starting stock in January and the sales invoices will be issued in the same month. They estimate that their maximum production capability in any month is some 320 boards, and this will be reached by March. This means that they will be unable to meet the initial sales estimates for March. Consequently they have revised their sales forecasts. Unlike sales, production levels have to be kept constant, although production is lower in August and December because of holidays. Forecast total production is therefore 3,780 boards (3,380 + 400), forecast sales is 3,140 boards, leaving 640 (3,780 – 3,140) boards in stock at the end of the year.

Table 1 Sales and production forecasts (in units)

Initial sales forecast	Jan	Feb	March	April	May	June	July	Aug	Sept	Oct	Nov	Dec	Total
Units	400	400	440	280	100	100	80	80	200	360	360	440	3,240
Production													
Start stocks	400*	180	20	0	40	260	480	720	800	920	880	840	
+ production	180	240	320	320	320	320	320	160	320	320	320	240	3,380
- sales	400	400	340**	280	100	100	80	80	200	360	360	440	3,140
= end stocks	180	20	0	40	260	480	720	800	920	880	840	640	

*pre-January production

**unable to meet sales estimate

The revised sales forecast is shown below in Table 2. The sales price of £135 (trade price) is net of delivery costs and represents the average of the three boards, since the best guess at the moment is that the boards will sell in equal proportions.

Table 2 Revised sales forecasts (units and £ value)

	Jan	Feb	March	April	May	June	July	Aug	Sept	Oct	Nov	Dec	Total
Units	400	400	340	280	100	100	80	80	200	360	360	440	3,140
£ value @ £135 per unit	54,000	54,000	45,900	37,800	13,500	13,500	10,800	10,800	27,000	48,600	48,600	59,400	423,900

Forecast income statement and breakeven

The founders need a range of machinery to produce their boards. They estimate that the total cost of this machinery will be £55,680 and that it will last some 8 years before needing replacement. Depreciation is therefore calculated at £6,960 per year (£8,700 in the first period of 15 months). They have also found a suitable unit that can be used as a factory. The annual lease cost for this is £11,520, including rates (£960 per month or £14,400 for the first 15 months). The founders intend to employ two factory workers immediately in October. They will be paid a fixed monthly wage – a total of £3,000 per month. An extra member of staff will be taken on in March, when production gets up to its maximum level. They will be paid £1,300 per month. The founders will also work in the factory and intend to pay themselves a fixed monthly wage – £2,000 per month, each – in the first year, starting in January. The estimated wages bill during the first 15 months (October to December) is therefore £106,000. The founders undertook a detailed costing exercise that showed that the average material costs for each board was £32 and the average variable factory overhead was £5 per board (consumables, electricity etc.). Total variable costs are therefore £37 per board. The average costs of producing a board is shown below in Table 3, based on target production of 3,780 units

Table 3 Average cost of board production

Variable costs:

Direct materials	£32.00
Direct factory costs	<u>£ 5.00</u>
	£37.00

Fixed costs:

Direct labour	£106,000		
Factory overhead	– depreciation	£ 8,700	
	– factory lease	<u>£ 14,400</u>	
		£129,100 ÷ 3,780	= <u>£34.15</u>
Total average cost of producing each board			<u>£71.15</u>

With a sales price of £135, the founders therefore estimate that they should make an average profit of £63.85 (47.3%) on each board, before other running costs.

They intend to spend £10,000 on promotional material in October. After that they estimate that their marketing and other general costs will be £3,000 per month (£45,000 in the first 15 months) and professional fees, paid at the end of the year, will be £3,000. These are all fixed costs.

The founders work out their breakeven point for this first 15-month period of trading by adding these to the fixed production costs and dividing by the

contribution margin of 72.6%. As shown in Table 4, this works out to be £257,576, with a margin of safety of 64.6%.

Table 4 Breakeven point

Contribution (Sales price – variable costs)	=	£135- £37 = £98 per unit
Contribution margin	=	£984÷£135 = 0.726 or 72.6%
Fixed production costs (15 months)	=	£129,100
Other fixed costs (15 months)	=	<u>£ 58,000</u>
Total fixed costs (15 months)		<u><u>£187,000</u></u>
Breakeven point	=	£187,000 ÷ 0.726 = £257,576
Margin of safety	=	(£423,900 -£257,576) ÷ £257,576 ×100 = 64.6%

The founders are very pleased that they have such a high contribution margin and, combined with keeping their fixed costs low, they have such a low breakeven point compared to their forecast sales. They feel that with such a high margin of safety in their first year, combined with a high level of advanced orders for their snowboards that they are really onto a winning business idea.

They go on to estimate their income for the 15-month period on sales of 3,140 units. This is shown in Table 5.

Table 5 Forecast profit

Sales	3,140 × £135	=	£423,900
Cost of sales	3,140 × £71.154	=	<u>£223,422</u>
Gross profit			£200,478 (47.3%)
Marketing and general costs	£55,000		
Professional fees	<u>£ 3,000</u>	=	<u>£ 58,000</u>
Net profit			<u>£142,477</u> (33.6%)

Forecast cash flow statement

The founders are convinced that their snowboards present a highly attractive opportunity, but they need to know how the opportunity can be financed, so they decide to prepare a cash flow forecast. This is shown in Table 6. There estimates are based on the following assumptions:

1. Sales receipts are lagged by 2 months.
2. Purchases for materials and other direct factory costs (£37 per unit) can be matched directly to production, which means at maximum production of 320 units purchases are £11,840 (320 x £37). Payments are lagged by 2 months, but payments related to the pre-January production of 400 units must be paid for in December (400 × £37 = £14,800).
3. Wages are paid monthly.
4. The £10,000 promotion expenditure will be paid in November. Other marketing and general costs are spread equally over the period.
5. Professional fees are paid in December.
6. Machinery purchased in September for £55,680 will be paid for in the following November.
7. Lease costs and rates are paid annually, in advance in October (£11,520).

Table 6 Cash flow forecast

£	Oct	Nov	Dec	Jan	Feb	March	April	May	June	July	Aug	Sept	Oct	Nov	Dec	Total
Receipts																
Sales						54,000	54,000	45,900	37,800	13,500	13,500	10,800	10,800	27,000	48,600	315,900
Payments																
Materials			14,800			6,660	8,880	11,840	11,840	11,840	11,840	11,840	5,920	11,840	11,840	119,140
Wages	3,000	3,000	3,000	7,000	7,000	8,300	8,300	8,300	8,300	8,300	8,300	8,300	8,300	8,300	8,300	106,000
Marketing	3,000	13,000	3,000	3,000	3,000	3,000	3,000	3,000	3,000	3,000	3,000	3,000	3,000	3,000	3,000	55,000
Prof. fees															3,000	3,000
Machinery		55,680														55,680
Lease	11,520												11,520			23,040
Net cash flow	-	-	-20,800	-10,000	-10,000	+36,040	+33,820	+22,760	+14,660	+9,640	+9,640	+12,340	+17,940	+3,860	+22,460	-45,960
Cash brought forward	0	-	-89,200	-	-	-	-93,960	-60,140	-37,380	-	-	-42,000	-54,340	-	-68,420	
		17,520		110,000	120,000	130,000				22,720	32,360			72,280		

Table 6 Cash flow forecast

Cash	-	-	-	-	-	-93,960	-60,140	-37,380	-22,720	-	-	-54,340	-72,280	-	-45,960
carried forward	17,520	89,200	110,000	120,000	130,000					32,360	42,000			68,420	

When the founders review this, they see that, despite the profitability of the company, there is a cash deficit in every month, with a maximum of £130,000 in February. The overall deficit for the year is £45,960. They also observe that the deficit is reducing by the end of the year, just as the primetime for sales (and cash receipts from sales) is approaching, and speculate that the deficit might be corrected in the following year. Because they do not want to share ownership of such a profitable business, they decide to put in £42,000 of their own capital – £30,000 in share capital and £12,000 by way of a two-year interest-free loan. They decide to seek bank finance – probably overdraft – for the balance of their funding. The revised cash flow forecast is shown in Table 7. It shows the maximum overdraft requirement is £88,000 in February but thereafter the requirement reduces rapidly. Nevertheless, they are aware that this is just a forecast and things can go wrong, so they decide to ask the bank for an overdraft facility of £120,000.

Table 7 Revised cash flow forecast

£	Oct	Nov	Dec	Jan	Feb	March	April	May	June	July	Aug	Sept	Oct	Nov	Dec
Net cash flow	-17,520	-71,680	-	-	-	+36,040	+33,820	+22,760	+14,660	-9,640	-9,640	-	-	+3,860	+22,460
			20,800	10,000	10,000							12,340	17,940		
Capital	+42,000														
Cash brought forward	0	+24,480	-	-	-	-88,000	-51,960	-18,140	+4,620	+19,280	+9,640	0	-	-	-26,420
			47,200	68,000	78,000								12,340	30,280	
Cash carried forward	+24,480	-47,200	-	-	-	-51,960	-18,140	+4,620	+19,280	+9,640	0	-	-	-	-3,960
			68,000	78,000	88,000							12,340	30,280	26,420	

Forecast balance sheet

The founders are now in a position to draw up a balance sheet for Xtreme at the end of the first 15 months of trading. They realize that they have assets that comprise machinery, stock of snowboards, money they are owed for sales (called debtors or receivables) and lease costs they have paid in advance (called prepayments). They also realize they owe money for the purchase of materials (called creditors or payables) and an overdraft. Their balance sheet is shown in Table 8.

Table 8 Forecast balance sheet

Machinery	Cost - depreciation	= £55,680 - £8,700	= £ 46,980
Stock	Number of boards × average cost	= 640 × £71.154	= £ 45,538
Debtors	November + December sales	= £48,600 + £59,400	= £108,000
Prepayments	9 months lease costs	= £960 × 9	= <u>£ 8,640</u>
Total Assets			<u>£209,158</u>
Creditors	November + December purchases	= (320 + 240 boards) × £37	= £ 20,720
Overdraft	from Cash Flow Forecast		£ 3,960
Founders' loan capital			£ 12,000
Founders' share capital			£ 30,000
Profit for the year			<u>£142,478</u>
Capital and liabilities			<u>£209,158</u>

Questions:

1. Work through all the financial projections of Xtreme SnoBoards, making sure you understand how they were constructed and where the information came from.

2. Do you think the assumptions on which they are based are realistic? If not, assess the effect of any changes you would make.
3. Going forward, do these projections alert you to any potential issues facing the company?

Chapter 17

Xtreme SnoBoards (3)

Evaluating a financial forecast

In Chapters 9 and 15 we saw how a couple of snowboard enthusiasts set up a company called Xtreme SnoBoards, designing and building three types of boards. They drew up a set of financial forecasts. Using the ratios outlined in this chapter, they now decided to evaluate the forecasted performance of their business in its first 15 months of trading.

$$\begin{aligned}\text{Return on total assets} &= \frac{\text{Net profit}}{\text{Shareholder' funds}} \\ &= \frac{\pounds 142,478}{\pounds 184,478} = 77.2\%\end{aligned}$$

$$\begin{aligned}\text{Operating profit margin} &= \frac{\text{Operating profit}}{\text{Turnover}} \\ &= \frac{\pounds 142,478}{\pounds 423,900} = 33.6\%\end{aligned}$$

$$\begin{aligned}\text{Gross profit margin} &= \frac{\text{Gross profit}}{\text{Turnover}} \\ &= \frac{\pounds 200,478}{\pounds 423,900} = 47.3\%\end{aligned}$$

$$\begin{aligned}\text{Contribution margin} &= \frac{\text{Contribution per unit}}{\text{Sales price per unit}} \\ &= \frac{\pounds 98}{\pounds 135} = 72.6\%\end{aligned}$$

$$\begin{aligned}\text{Margin of safety} &= \frac{\text{Turnover} - \text{Breakevenpoint}}{\text{Turnover}} \\ &= \frac{\pounds 423,000 - 257,576}{\pounds 423,900} = 39.2\%\end{aligned}$$

$$\text{Total asset turnover} = \frac{\text{Turnover}}{\text{Total assets}} = \frac{\pounds 423,900}{\pounds 209,158} = 2.0$$

$$\begin{aligned}\text{Debtor turnover} &= \frac{\text{Turnover}}{\text{Debtors (receivables)}} \\ &= \frac{\pounds 423,000}{\pounds 108,000} = 3.9\end{aligned}$$

$$\text{Stock turnover} = \frac{\text{Turnover}}{\text{Stock (inventory)}} = \frac{\pounds 423,000}{\pounds 45,538} = 9.3$$

Although the founders do not have any industry norms and there are no trends to observe in the first period of trading, they feel that this is an exceptional level of performance by any standards, reflecting a high profit margin and strict cost control. However, they are aware that they have accepted a lower salary than they wish (estimated as an additional £20,000) and provided an interest-free loan for the company (estimated as an interest cost of £2,000). They calculate that if these costs had been charged, the return on total assets would be reduced to 65% and the operating profit margin to 29% – still very good. The debtors turnover reflects the 2-months credit terms they require from shops, and the high stock turnover reflects both the high value added reflected in the board price and the minimal stocking policy they are trying to adhere to.

The high margin of safety leads them to believe that this is a relatively low-risk venture. The pair do intend to pay themselves more in the second year of trading; however, a quick calculation shows them that they could double their salaries and still make over 50% return on total assets at this level of profitability. This gives them confidence that, if all goes according to plan, they should look forward to expanding the business in its second year.

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}} = \frac{£162,178}{£24,680} = 6.6$$

$$\text{Quick ratio} = \frac{\text{Current assets, excl. stock}}{\text{Current liabilities}} = \frac{£116,640}{£24,680} = 4.7$$

Despite the early need for cash, the business looks highly liquid by the end of the first period because of the high value of debtors, compared to creditors, again reflecting the high value added in the board price. The pair are, however, very aware that earlier in the year, when the actual overdraft was far higher, these ratios would have been much lower.

$$\text{Gearing} = \frac{\text{All loans + overdraft}}{\text{Shareholders' funds}} = \frac{£15,960}{£184,478} = 8.7\%$$

Not only is this gearing level low, the outstanding interest-free loan is from the founders and not from an external borrower. This encourages them to think that not only might the company repay their loan early next year, but it also should be in a very strong position to borrow money to expand. The founders conclude that these financial forecasts look very encouraging. However, being inherently cautious, they are aware that they are just forecasts and the pair will have to work hard to turn them into reality.

Question:

1. Do you agree with the founders about the projected performance of the company? What reservations might you have?

Chapter 20 Xtreme SnoBoards (4)

Valuing a private company

In Chapters 9, 15 and 17 we saw how a couple of snowboard enthusiasts set up a company called Xtreme SnoBoards, designing and building three types of boards. They drew up a set of financial forecasts and they undertook an evaluation of the projected performance using ratio analysis. They were very pleased with the results and, although they were not thinking of selling the business so early, they were curious about how much it might be worth if they achieved their targets.

Starting with basics, they would have put £42,000 of their own money into Xtreme and built a company with approximately £184,000 of capital or net assets (although almost £50,000 of this would be represented by machinery that may or may not have this market value). Against this, they would have liked a higher salary and did not take interest on the loan to the business. This would have reduced profit and assets by approximately £22,000. Still, if they could realize or sell the assets for £184,000 that would make the venture worthwhile.

However, they had learned that a thriving business was normally valued as a multiple of its profits, and with net profits of approximately £142,000 (or £120,000 after their additional salary and interest) they tried to find out what that multiple might be. The problem was that nobody would give them a firm indication of what that might be. On the one hand they were told that the business probably had great future potential, but on the other hand it had no track record and the stock market was generally depressed because of the recession. The multiples they were given ranged from 20 to 3, although most thought at this stage the multiple was probably in single digits. This wide range valued the company at anything between £426,000 and £1.7 million (or £360,000 and £1.4 million after their additional salary and interest) – quite a lot more than the net assets.

The founders were astounded. Taking the net asset value and the lowest multiple of income the company would be worth something between £184,000 and £426,000 (£162,000 and £360,000 taking the additional salary and interest into account). Not bad for a £42,000 investment and a lot of hard work over 15 months. Whichever way they looked at it, if the forecast was achieved, the business would be highly successful, and that made them even more determined than ever.

Question:

1. Is the valuation of the company realistic? Explain.

Chapter 19 Solar Power Company Group (SPCG)



Obtaining finance for new technology

Khunchornyakong Wandee is founder, chief executive and chairwoman of what is now the largest solar power generating firm in Thailand, Solar Power Company Group (SPCG). The company has created thousands of jobs and runs 36 solar farms, generating some 260 megawatts of solar power a year. Khunchornyakong is also in the top 50 of Thailand's richest people. Despite solar power being in its infancy at the time, she was so convinced of the sector's potential that she set up SPCG in 1993. But getting started was not easy. She had some experience in the use of solar energy in rural areas, and the government's offer to buy solar power from private firms when there was little provision in Thailand led her to believe in the opportunity.

Nevertheless, she could not find a single bank willing to fund her first project. None of them believed it would be profitable. Eventually she persuaded a bank that sported a green logo, indicating that it supported environmental projects, to lend her money – but only after creating a fuss, insisting that the bank should change the colour of its logo if it would not lend money for this sort of project. The bank offered a loan for only 60% of the start-up costs and she could not find any other backers, even amongst friends who had invested in her previous business ventures. So she decided to use her house as collateral for the balance. Only when the first project proved to be successful was she able to secure more finance to expand the business. By 2014 external finance reached over \$800 million in leveraging finance by the International Finance Corporation (IFC) and the Clean Technology Fund which unlocked domestic funding. Khunchornyakong still owns 54% of the company and has the IFC and Kyocera among key investors. In 2013 she was named Women Entrepreneur of the Year by the Asia Pacific Entrepreneurship Awards.



Access the Digital Links booklet to visit the company website and to watch Khunchornyakong Wandee speaking at a conference.

Question:

What lessons do you learn from Khunchornyakong Wandee's perseverance?

Chapter 20 Cobra Beer



CVAs and 'pre-packs'

Cobra Beer was set up in 1990 by Karan Bilimoria, the son of an Indian army general and a former accountant, to sell a different type of beer to Indian restaurants.

'I entered the most competitive beer market in the world against long established brands. The product itself was innovative – an extra smooth, less gassy lager that complements all cuisine and appeals to ale drinkers and lager drinkers alike ... Deciding to import the beer in a 650ml bottle was important in positioning the product within the market and raising the profile among restaurant owners. It also promoted a new, shared way of drinking ... The brand's point-of-sale items, such as unique and different glasses, were another effective way of establishing brand awareness ... Also [the glass] is embossed with six icons telling the story of Cobra beer, from concept and production to growth and development, and this is the first time in the world that, to our knowledge, the brand has incorporated its story directly into its packaging.' (The Times 23 May 2004)

By 2009 the company had sales of £177 million, but there was one problem. It had yet to make a profit. Indeed, in the year to July 2007, the last year for which accounts are publicly available, Cobra lost £13 million. Instead of tracking profits, Cobra had focused on sales growth, spending £40 million on marketing since its launch. Sales growth had indeed been spectacular, showing 20% year-on-year growth in a falling market. Unfortunately, the 2008 recession took its toll. While growth stalled, the banking crisis made it impossible to secure fresh funding. In the autumn of 2008 Bilimoria tried to find a buyer for the business, but the big brewers were not interested and the credit squeeze prevented a sale to a private equity firm. He cut costs. Four directors stood down and staff numbers were cut from 150 to 50.

Bilimoria called in the accountants PricewaterhouseCoopers in the spring of 2009 to work on a company voluntary arrangement (CVA). This would have given all creditors some money back, but one creditor, Wells & Young's, which brewed Cobra under licence in Bedford, vetoed the proposal. Bilimoria therefore decided to restructure Cobra in what is called 'pre-pack' sale. In this arrangement the business was acquired by a joint venture company comprising Molson Coors, the US brewer of Carling lager, and the former owner, Bilimoria. Molson paid £14 million for its 50.1% share. Karan Bilimoria kept 49.9% and remained as director.

The nature of this form of administration in the UK means that, while the secured creditors, largely banks, who were owed some £20 million were paid back in full, 340 unsecured creditors, who were owed some £72 million, got nothing. These debts included £57 million to investors, £6 million to the government in taxes and £6 million to 330 small unsecured trade creditors. These included many small businesses such as Spark Promotions UK, owed £62,018 for developing a beer pump for Cobra; Pop Displays, owed £31,129 for producing printing and packaging for Cobra promotions; and MicroMatic, another pump maker, which was owed £60,143. They were not happy:

'[Bilimoria] has risen from the ashes like a phoenix while people like us, the creditors, have been burnt alive.

Brian Flanagan, MD Spark Promotions UK, *The Sunday Times*, 2 August 2009

'How can someone dump all their debts on creditors and then the next day walk into what is, effectively, the same business with a 49% stake?'

Chris Hall, MD Pop Displays, *The Sunday Times*, 2 August 2009

While the unsecured creditors may have lost out observers point out that, as well as Bilimoria retaining 49.9% of the business, Molson Coors landed a 'fantastic' deal. Bilimoria said he lost the £20 million he invested in the firm and insists he is committed to repaying as many debts as possible:

'We had no choice but to go down this route. I feel terrible about that. I feel gutted that the unsecured creditors aren't going to be paid.' (*The Sunday Times*, 31 May 2009)

These accusations have continued to haunt Bilimoria. However he is a great networker and was made a Lord in 2000. Nor have the accusations hindered him receiving a raft of awards and appointments - his Lords profile lists 45 different roles. Commenting in 2019, when he was Vice President of the Confederation of British Industry (he became President in 2020), he responded:

'What have I been doing for the past ten years? I'm doing my utmost – as long as it takes ... I could have wiped out more of my creditors, wiped out my shareholders, paid my employees just statutory redundancy, and I would have done thing perfectly legally.' (*The Sunday Times*, 25 August, 2019)



Access the Digital Links booklet to visit the company website

Questions:

- 1 What was Cobra's business model and what were the key elements of competitive advantage in its value proposition up to 2009?
- 2 Was Cobra successful up until this point? Was its strategy prudent?
- 3 Who has paid for the growth of Cobra? Is this fair? If not, what are the alternatives?

Chapter 21 Kongō Gumi



The oldest firm in the world

Up until its takeover in 2006, Kongō Gumi could probably have claimed to be the oldest continuously operating firm in the world. Founded in 578 by a carpenter brought to Japan from Baekje (now Korea) by Prince Shotoku to build a Buddhist temple, the Kongō family built some of the most famous buildings in Japan, including many temples and Osaka Castle. In fact, temple construction had until recently been a reliable mainstay of the business, contributing 80% of Kongō Gumi's \$67.6 million turnover in 2004. The family owned and managed the business for over 40 generations.

Kongō Gumi's leaders had some remarkably modern management concepts. The company's 32nd leader, Yoshisada Kongō, had a creed, later titled *Shokuke kokoroe no koto*, or 'family knowledge of the trade', which listed 16 precepts intended to guide and preserve the family business in the future. The creed stressed quality of work. Carpenters had to undertake a ten year apprenticeship. They were organized into *kumi* or workgroups that often competed against each other for quality. The importance of maintaining good customer relations was also emphasised and as a result many customers stayed loyal over the centuries. It stressed close, stable and mutually beneficial relationships - Chapter 16 stressed the importance of recognising reciprocal obligations and developing 'relational contracts' as part of good leadership. Precepts such as: 'Listen to what the customer says', 'Treat the customers with respect' and 'Submit the cheapest and most honest estimate' have a very modern resonance.



The Horyu-Ji, a temple in Irakuga, Nara Prefecture, built by Kongō Gumi.

The creed also includes personal issues such as how to dress (in keeping with one's station), how much to drink (in moderation) and how to treat others (with utmost respect). Other precepts include: 'Do not put yourself forward', 'Never fight with others', 'Do not shame a person or boast' and 'Communicate with respect'. The creed also emphasises the importance of maintaining the name of the Kongō family. However the company has been flexible in selecting its leaders. The company's last president, Masakazu Kongō (the 40th member of the family to lead the company) cited this flexibility as a key factor in its longevity – rather than always handing reins to the oldest son, the son or daughter who best exhibited the 'health, responsibility, and talent for the job' was selected. Indeed, the common Japanese practice of

sons-in-law taking the family name allowed the company to continue under the same name, even when there were no sons in a given generation.

In more recent years the company has had to be more flexible in the building contracts it undertook and in the year of its takeover it still had a turnover of \$70 million and some 100 employees – despite falling sales and redundancies. The underlying reason for its takeover was the long-term decline in temple building. However a high level of debt (\$343 million), brought about by heavy investment in property coupled with the bursting of the Japanese property bubble in the 1990s also contributed to the company's decline. It now operates as a wholly owned subsidiary of Takamatsu and the Kongō family members and employees continue to build and maintain temples.



Access the Digital Links booklet to watch a video charts the company's history and looks at some of the temples it has built.

Questions:

1. What are the lessons from Kongō Gumi's longevity?
2. What are the lessons from Kongō Gumi's decline?
3. Which of the Kongō Gumi precepts do you recognise from this book?
4. What are the advantages and disadvantages of the age of a business?

This case is based upon an article by Irene Herrera, *Work That Works*, No. 3. Available on: <https://worksthatwork.com/3/kongo-gumi>)

Chapter 21 Everards Brewery



The family constitution

Everards Brewery is a family company that was founded in Leicestershire in 1849. It brews beers such as Tiger Best Bitter, Beacon Bitter and Original from its Castle Acre site near Leicester, and has a pub estate of some 170 units. The fifth-generation Chairman is Richard Everard. He sees himself as the 'custodian' of the family assets in the business. When he became Chairman he sat down with the family deciding on the family objectives and set about changing the business strategy to reflect them:

'After five generations, 90 per cent of the shares are held by only two family members ... There is a rule that only one family member can have an executive position on the board in any one generation ... We do not offer share options to attract senior people. That would be against our philosophy ... I see my custodianship lasting another twenty years, but should anything happen to me I have left clear instructions on how the next generation should be trained for the position. This would include at least four years of external training.' (Family Business, The Story Centre for Family Business, 7(3), 1999)

Fast forward to 2020 and things have not changed that much. The company now only offers pub tenancies and property now generates more income than brewing. Non-family member Stephen Gould is Managing Director and the company is building a new brewery called Everards Meadows, which will have a visitors centre, beer hall, shop and offices. It is due to open in 2021.



Visit the website: www.everards.co.uk

Questions:

How much of Everards' longevity might be because it has only two principle shareholders? Explain.