

Key Business Considerations



1. Anand has been working in the building industry for around ten years, but after finishing a TAFE course has now decided that he wants to start his own business. He wants to work in home building, in particular in doing extensions and renovations. He has the choice of starting up a new business, buying a declining local building business or buying a franchise from Oasis Homes, which has advertised itself as the one-stop shop for building needs and has around 30 franchises around the state. Write a report to Anand advising him about the different choices.

Executive Summary

This report will outline and assess the various methods of starting up a new business in the building industry. In particular it will focus on the advantages and disadvantages of each method, and discuss considerations that must be made. The report will focus on methods such as starting up a new business from scratch, buying an existing business, and purchasing a franchise.

Starting up a new business from scratch

When starting up a new business, there are some important considerations such as:

- How much capital is required?
- Where will clients come from?
- What is the nature of the industry?
- What constitutes best practice?

All new businesses must make sure they have sufficient capital before starting up. Many new businesses fail due to liquidity and working capital problems. The first 12 months of a business can be the most critical in determining the overall success or failure. Starting a new business from scratch is often difficult because forecasting capital requirements is not easy. For example, when starting a new building business, unexpected overheads such as high equipment costs, insurance, and advertising may mean that initial financial outlays, are not adequate.

Other challenges include finding a reliable and steady flow of clients. Whilst existing businesses can rely on a reputation, and repeat customers, new businesses must build up their client base from scratch. This often means that revenue may be slow to build up in the first stages of the business life cycle. New businesses must spend an appropriate amount of money and time on advertising, and building up networks. For example, a building business may wish to advertise in directories such as the yellow pages, and build up networks with other businesses in order to develop a clientele.

Starting a successful business requires an intimate knowledge of the industry. A typical industry analysis involves looking at competitors, suppliers, alternative products, and buyers. Each of these plays a role in the industry dynamic, and determines the relative position of a business within that industry. Having a distinct knowledge of the industry is important as it determines a set of guidelines on which a business can act. For example, the building industry is fairly fragmented without any dominant power within the industry. This may afford opportunities to differentiate and cater for a niche market such as housing construction.

Often new businesses fail as they do not implement industry best practices. Over time, operations within a business become streamlined, and improved. As these improvements become the industry norm, it is impossible to remain competitive unless such practices are adopted. New businesses may not have the knowledge of these processes, or may not have the size to implement them (as they may require significant amounts of money, or personnel). For example, established building businesses may utilise management accountants in order to streamline the financial side of a business – whereas a new business may not have access to such expertise.

Despite these challenges; starting a new business offers the highest returns if successful. The risk of failure is high, however can be managed if enough preparation and planning takes place.

Buying an existing business

Buying an existing business may overcome some of the challenges brought about by starting a new business; however some new challenges may arise such as:

- Where is the business heading?
- How valuable is the business's goodwill?
- What are its Strengths / Weaknesses – Opportunities / Threats?
- Is the business worth the sum of its parts?

Many businesses for sale in private markets (i.e. not the stock exchange) are often sold as they are no longer profitable for their owners. In particular, when considering a declining business, profitability must be carefully addressed. Some businesses may be in need of a new direction which can be provided by new owners. This transition can often rejuvenate a business. Other businesses can be purchased simply for their assets. For example the purchase of a building business in decline may be worthwhile as it may provide equipment, networks, and a reputation. Other businesses fundamentals such as marketing can be altered in order to breathe new life into the business.

All businesses have some degree of goodwill. Goodwill refers to the intangible value of a business's clientele. Businesses have many clients, however some of these may be repeat customers. These repeat customers (attracted by their previous experience with the business) are one aspect of goodwill. Another aspect of goodwill can be represented by the reputation of a business. A business's reputation can be either good or bad, and is likely to either attract or deter customers accordingly. It is important to consider the goodwill of a business when purchasing an existing business. For example a building business may have a bad reputation due to inferior construction. This may in turn damage the reputation of a new owner.

A business can be valued in terms of its internal capabilities (strengths and weaknesses) and its external environment (opportunities and threats). A business with significant strengths and opportunities is likely to be more valuable than one with significant weaknesses and threats. A SWOT (Strengths, Weaknesses, Opportunities, and Threats) analysis is useful in comparing businesses, and determining whether it meets the needs of the potential owner. For example, a business with bricklayers is likely to be useful for an owner who wants to specialise in that area.

Another important consideration is to determine whether or not a business is worth its constituent parts. For example, a failing business in need of an entrepreneurial makeover may be on the market for an amount that exceeds the value of its assets. If this is the case, it may be cheaper to start a business from scratch. Alternatively it may be worthwhile paying a higher amount for a successful existing business.

Purchasing an existing business may be a better option than starting a new business in that the foundations of the business already exist. It is only the viability of these foundations that must be considered.

Purchasing a franchise

Franchises rectify many of the difficulties brought about by the purchase of an existing business. They are generally successful business models that can guarantee success. Some considerations must still be made:

Is the cost worth the return?

Is the market saturated?

Does it provide the flexibility required?

Franchises are generally expensive. Aside from the initial investment requirements, a franchise fee is also payable. This may also extend to a percentage of sales fee. A potential franchisee must consider the capital outlay required, as well as the expected return. Not all franchises are successful. A building franchisee must make sure that the profits earned adequately reflect the investment, and workload of the builder.

Franchisors are in the business of making money. They are often keen to sell their franchise to as many entrepreneurs who are willing to buy a franchise. This often leads to a saturated market whereby franchisees compete with one another leading to lower profitability. Whilst franchisors usually work on a territory system with an allocation of geographic area to each franchisee, these areas also restrict potential customers who are located outside of the area. When considering a building franchise, the possibility of saturation must be considered. For example, Oasis homes has 30 franchise businesses across the state. This may be a saturated market.

Franchise businesses usually rely on standardised business models. There may be little room for variability in these practices, and subsequently the franchisee may be left without the flexibility they desire as a business owner. A building franchisee must consider whether the franchise arrangement offers them adequate opportunity to develop their business in the direction they wish.

Franchises usually offer the lowest risk. They usually guarantee a customer base, and are based around a successful business model. The capital outlay is usually higher than other methods, however this capital outlay is usually predetermined and varies less than if starting a business from scratch.

Conclusion

Ultimately, the method of starting a new business should reflect three things:

- willingness to take risk
- available capital
- entrepreneurial ability.

Each of the three methods provide different levels of risk, however the riskier the method, the higher the potential return. It is this relationship that must be considered. If a higher degree of risk is willing to be taken, then starting a business from scratch may be the preferred method as it offers the highest return if successful. Alternatively, if Anand is risk averse, a franchise may be a safer way to go.

Each option requires a different amount of capital. Starting a business from scratch will usually be cheaper. However, the amount of investment required is harder to predict than when purchasing an existing business or franchise. If capital is scarce, then it may be safer to buy a lower cost business or franchise.

Different people have different levels of entrepreneurial ability. If business skills are lacking, then a franchise may be a way to overcome this. Alternatively, those with an entrepreneurial vision may find themselves restricted by a franchise and prefer starting a business from scratch.

2. Anand has now decided that he wants to start his own business. He needs to get a showroom to attract customers. Advise him on what factors he should take into account in choosing the best location for the business.

Obtaining a physical presence is often one of the most challenging aspects of starting a new business. Nonetheless it is one of the most important determinants of success or failure for a business. Some considerations include the following:

Visibility – For businesses that require a direct customer relationship, visibility is of prime importance. Businesses located in highly visible areas will create awareness amongst potential clients, and will attract customers more readily than those in areas of poor visibility. Not all businesses need to be in high visibility areas. Retail based businesses tend to rely on ‘walk ins’ and require highly visible locations. Other businesses may be able to locate suitably in less visible areas as they do not have this direct relationship with their customers.

Cost – Commercial property can be quite expensive. While some locations may attract more customers than others, these locations tend to be more expensive. Businesses must identify the nature of their business, and determine whether it is worth paying a premium for a highly exposed location.

Proximity to suppliers – Businesses will have a network of suppliers. The proximity of a business to these suppliers will affect the cost of obtaining inputs (due to transportation costs) and the speed for which they can be obtained. Depending on the nature of the business, these characteristics may be of significant importance.

Customers – Businesses need to be located near their customers in order to maximise their clientele. Depending on the nature of the business, customers may be unprepared to travel long distances.

Support Services – Businesses rely on various support services in order to operate. These can vary widely and may include outsourced services such as accountants or lawyers. Businesses also rely heavily on their workforces in order to remain competitive. Businesses must locate in areas where they can adequately meet their operational needs. Businesses tend to locate in common areas (such as Sydney’s CBD) in order to be close to such support services, and attract employees.

Anand’s business would likely benefit from a location in either a homemaker centre or industrial park where customers seeking home improvements tend to shop (i.e. his target market). This will also benefit Anand, as rentals on properties in such locations tend to be lower than in other general retail areas (such as shopping centres).

3. Anand needs to obtain around \$200,000 to get his business started. He only has \$50,000 of his own, but his parents are willing for him to borrow the rest using their home as the security for the loan. Alternatively, he knows of a small business investor who would be willing to contribute the full sum in exchange for a 51% share in the business and an agreement about how much Anand would be paid. Advise Anand on what factors he should consider as he makes his choice.

Anand should consider the following factors:

Source – Different sources of finance have different benefits. Equity finance refers to either owner's equity (money put into the business by the owner) or retained profits (residual profit re-invested into the business). Equity finance changes the ownership of the business. If Anand offers a 51% stake of the business to a potential investor, he is no longer in control of the business.

Cost – Some sources of finance are cheaper than others. Anand must consider the interest rate payable on the business loan. Equity finance is advantageous as dividends are only paid if the business is profitable. Debt finance on the other hand requires an interest repayment irrespective of business profitability, and is thus more risky.

Gearing – Businesses may have a preferred level of gearing within a business. Gearing refers to the ratio of debt to equity within a business. Debt finance is often seen as a riskier form of finance due to interest repayments, and the potential for rising interest rates. Subsequently, many businesses prefer to reduce the level of debt financing.

Debt finance issues – borrowing money against the security of his parents' home raises the issue of debt repayment. Other issues to consider include what will happen to his parents if the business fails and Anand defaults on the loan.

If Anand is unable to find another suitable investor, he should consider the implications of giving a majority shareholding (51%) to his current investor. In this case equity finance may not be desirable. On the other hand, the risk associated with debt finance may be a deciding factor. Anand should consider the level of risk he is willing to take when deciding upon a financing method.

4. Anand needs to make sure that he complies with relevant laws for his building business. Explain to him what legal factors he should consider.

Anand needs to carefully analyse the various laws that apply to all businesses, as well as those associated with the building industry. Anand should consider some of the following:

Registration of Business Name – Virtually all businesses must register their business.

Registering a business usually involves registering a business name, and acquiring an Australian Business Number (ABN). Various considerations must be made when choosing a name. Trade marks are often ruthlessly protected, so it is essential that the business name is unique.

Zoning – Many local councils have zoning laws that determine what type of properties can exist in certain locations. Usually residential and commercial areas are kept quite distinct and separate. Businesses must make sure that they locate themselves in the appropriate area.

Health Regulations – It is important for Anand to follow various health regulations. A major consideration for the building industry is Occupational Health and Safety (OH&S). OH&S involves improving workplace safety by implementing required health and safety standards such as wearing hard hats on building sites or erecting scaffolding when working at more than a specified height.

(9. continued)

Trade Practices – Anand must also follow the trade practices act which outlines the terms and conditions of sale. Anand needs to become familiar with both the rights and responsibilities of the business and customers' rights.

Patents – Businesses may also consider the use of patents in order to protect key innovations that contribute to a business's competitive advantage. Patents legally protect an idea from being copied by other businesses.

5. What advice would you give Anand about the importance of supply and distribution arrangements for his business?

Anand must ensure that he can appropriately establish supply and distribution networks. Businesses are like any system: they take in inputs, process them, and produce outputs. It is essential that a business can develop a comprehensive network of suppliers in order to maintain a constant and reliable source of business inputs. Likewise, it is essential for Anand to have appropriate distribution arrangements. Because Anand is likely to open a service orientated business, he may choose to work in alliance with other similar businesses. With a reliable network of businesses, Anand can maintain a steady stream of work.

6. Anand now realises he will need at least three staff to assist him, including someone to manage the showroom, someone for the administration, and another builder. He will also need subcontractors. What advice can you give him about where he could find these employees?

Anand has many options when looking to hire staff. Anand can hire staff himself by advertising in the local newspaper and taking applications as they arrive. Anand can then review the applications, and invite suitable candidates in for an interview. Alternatively, Anand can utilise a recruitment company to hire suitable staff. Recruitment companies specialise in hiring suitable staff for specialised positions. While this may present a significant cost to the business, it may be cheaper in the long run as candidates are usually of higher quality.

7. What opportunities for outsourcing might exist in Anand's building business? State the benefits of outsourcing for his business.

There are a diverse range of opportunities for Anand to outsource within his business. Outsourcing involves paying a service fee to a specialist business to perform a specific function or activity within a business. Anand can outsource the following areas:

Operations
Staffing
Accounting
Marketing

Anand may benefit from outsourcing as it is a way for smaller businesses to gain specialist knowledge within areas of a business. Small business owners tend to be fairly busy, and can save themselves time for more important work by outsourcing. Given the efficiencies achieved by outsourcing companies, they can also end up saving money. While Anand will need to pay a fee, this fee may be less than the costs of doing it himself.

8. Discuss the key taxation issues that Anand needs to plan for in operating his business.

Anand must consider a range of taxation issues when establishing an accounting framework for his business. All businesses in Australia must pay tax on profits earned. The amount payable depends on the structure of the business. Incorporated businesses pay 30% tax for every dollar earned, whilst sole traders pay tax equivalent to progressive income tax rates. Aside from taxes on profits, Anand must also consider indirect taxes such as payroll tax. Many of these taxes are collected by state governments and vary between states. Anand must also collect GST on all products and services sold. Whilst this tax is not payable by Anand himself (the tax is on consumers), the tax must be collected and transferred to the Australian Tax Office. Anand must also perform various tax-related duties on behalf of his employees. Anand must collect PAYG (Pay As You Go) tax on his employee's earnings. As well as doing this, Anand is responsible for setting aside 9% of his employees' income in the form of compulsory superannuation.

9. Having considered the issues of how to start the business, its location, staffing, and legal and tax issues, discuss which you think present the greatest risk to Anand's business being successful.

Risk associated with Anand's proposed business venture come from many sources. Each source of risk must be carefully considered when deciding upon the viability of his business proposal. The issue which presents the most risk to Anand depends on the external environment in which he is operating. Anand must determine his ability to capture an adequate portion of market share. This will depend on external factors such as competitors – but will also depend on his internal strengths and weaknesses. Even if Anand can obtain a significant portion of the market this is no guarantee of success. Anand must make sure that he is able to turn a profit by maximising revenue, and minimising costs without limiting growth opportunities. Considerations of location, staffing, legal and tax issues all present risks to Anand which affect him in a very unique way.