The journey to obtaining your business' effort-return equilibrium

By James Maposa

22 Dec 2016

For most entrepreneurs, starting a new business is like an uphill skate. You dig your deepest, grit your teeth, flex all of your propulsion muscles and give your sled the biggest push your body can make. For all that effort, the sled only moves an inch... Your next move is one of two things: either you think of the act as irrational and call it quits or your dig even deeper than your deepest and keep on pushing until you get to the top of that hill.

For all believers in hard work, perseverance pays. But sometimes working hard doesn't mean you're doing it right. As an astute business man you need to know when to quit.

© rawpixel via 123RF

One of the telling signs is when you're spending more than you're earning. No matter how hard you try, the colour of your financials remains red. What should alarm you even more is the negative getting bigger. I posit that a good time to quit would be when your losses are so big that even the business' owned assets aren't able to pay off the debt. Although this may sound logical, most people don't know when to quit. In as much as we're driven by profit when starting and running our business, we're also emotionally connected to our business and use it as a platform to build our personal and family legacies. So whenever we encounter a problem, we think of it as an obstacle we can overcome. As the mound gets bigger, we start telling ourselves that others have seen worse and if they could overcome the setback, so can we. We unfortunately never get full exposure on how these companies really overcame what brought their businesses to within an inch of their existence. We're blinded by belief and continue to press on until it's too late.

Determine the level of opportunity

To avoid poor returns, prepare, prepare, prepare. Proper preparation prevents poor performance. From a preparedness viewpoint, first have a good understanding of the industry within which you would like to start your business. Having an informed understanding of your industry's fundamentals enables you to know how best to position your business to carve a niche and maintain a competitive advantage to other industry participants – existing and future. Knowing your industry also enables you to quantify the opportunity available for your business and whether that opportunity would remain viable, even if existing participants were to target the same opportunities and / or new businesses enter the market. For example, if industry returns range between 15% and 20% and the opportunity you've identified delivers a return of 30% to 50%, rest assured that existing industry participants would also like to be a part of that action. New entrants will also want a piece of this pie, particularly if they're coming from an industry where the returns are much lower and the effort required to obtain them is also significant. So a good starting point will be to determine the level of opportunity and from there assess its viability from a worst case perspective. If it remains relatively positive, the next step will be to do an internal capabilities assessment.

Internal preparedness is aimed at answering the how. That is: how do we tap into the identified opportunity and what do we have to leverage as a business to take full advantage of the identified opportunity? For instance if your business happens to own human resources that have led to the development of a particular industry or area within the industry, how do you use these resources to enable you to fully exploit the identified opportunity? Innovation comes in many different ways including being inventive, doing things quicker, using fewer resources, customising solutions to cater to diverse needs and so many more. Understand your industry well enough to know how to develop internal capabilities and processes that support you to fully exploit the identified opportunities and also to do it in a manner that is better than your competitors – existing and potential. Internal capabilities also refers to having some understanding of how your competition would also exploit the given opportunity and how you can differentiate yourselves to them in a way that obtains higher client buy in. Leverage this differentiation as your unique selling point and use it to full advantage. After determining your key differentiators, quantify how much it will cost you to deliver the products and services, bringing this down to a unit cost. Compare this cost to how much it would cost to sell one unit of the product / service in your given industry. From there determine whether it still remains viable from a cost and returns perspective, including comparing this to industry and your chosen niche averages.

Prepare for all costs

An important point to remember during the internal capabilities assessment is also to factor in your asset and overhead costs. Calculating your unit production / service costs only takes account of your production costs. Your assessment should also take into consideration the assets the business needs to acquire and overhead expenses associated with successfully running your business. Add these costs to your unit production / service costs and inflate them based on the premise that you do not have full control on how these costs will track over a given year. An example is fuel costs whose per litre pricing is dependent on global demand, global supply and associated taxes. In addition to adding these costs, have an understanding of your industry's business risks, figure out some way of monetizing these risks through research and add these costs to your operating costs as well. An example is where you're operating in an industry which has high staff turnover, with the training costs also being exorbitant. Add the risk costs to your unit operating cost as well and then deduct these expenses from your per unit sales. If the return still puts you in a viable position, move on to assessing your market.

Know your customer

Knowing your customer gives you an indication of how much your customers are willing to spend for your product / service; including the limit of how high you can raise your prices. In addition, speaking to your customers allows you to understand what they would substitute your product / service with. As an example, based on research conducted with a leading satellite television company, the client found it interesting that its competition was not the other television companies, because there was a standard number of hours that the average person watched television. The satellite television channel's competition consisted of other forms of entertainment including watching a live sports game, hanging out at the local pub, etc. Post delivering this information, they changed their marketing initiatives not to outcompete their direct competition, but rather to entice people to do less of the other forms of competition based on it costing more than the product / services that they offered. So know your customers well enough to determine average demand from a worst case scenario, including pricing point thresholds. Factor this information into your viability assessment, comparing this to operating expenses and average selling price. This will give you a realistic assessment on whether the opportunity is worth your while or not.

Based on the viability assessment, you can also develop proxies that serve to inform you on whether it is still worth your while to stay within the industry or operate your business as usual. An example is in the mining industry where the mining companies are price-takers and will implement production holidays if the cost of production is higher than the prevailing global price based perhaps on aspects such as oversupply. The developed proxies allow you to have a high-level understanding of industry dynamics and whether you need to change a few things around your business to remain profitable even in turbulent times. At the end of the day, the viability assessment gives you a clear idea of whether the effort you apply will deliver the result you desire even during the worst of times. Making it through the worst of times implies that your business will deliver returns that enable it to withstand the test of time.

ABOUT JAMES MAPOSA

Maposa is the founder and managing director of Birguid, a research and advisory company. Maposa has 15 years work experience, mostly spent in research and strategy consulting. Maposa is passionate about socio-economic development, business growth and continuity.

- To succeed, don't be an island... - 13 Jun 2019
- Not another consultant is what Africa needs - 28 Dec 2018
- Consider partnering to progress your business - 25 Jan 2017
- The journey to obtaining your business' effort-return equilibrium - 22 Dec 2016
- Community support critical to driving African entrepreneurship - 10 Nov 2016

View my profile and articles...