THE Business Owner®

Expertise for the business owner since 1977

The Business owner®

How to Compete Against the Big Dogs

Big is good. When you're big, you can throw your weight around. And maybe more important, you get noticed. In business that's half the battle. How nice would it be if your company was the one that popped into people's minds?

Unfortunately, you're not the big dog on the block. Neither am I. We share a common struggle. Our competitors have more products, more locations, more awareness, more marketing, more salespersons, more money, and more press attention. How are we supposed to compete against that?

To be sure, it's not by squaring up right in their wheelhouse. No, our only chance is to be crafty. Smart. Strategic.

What did David do when he went up against Goliath? He used his brains instead of his brawn. He hatched a plan that gave him a fighting chance. He stood his distance and used a special, albeit nontraditional, means of combat — a slingshot.

No doubt Goliath expected David to conform to the accepted and manly battle stance — a toe-to-toe brawl, the same way every other unimaginative competitor had ensured defeat before the battle had even begun.

So there Goliath stood — self-absorbed with his own greatness and completely unprepared for the unique attack plan that resulted in his demise — and the rise of a new leader.

Are you up against Goliath? Sure you are. Like David, the only way you can win is to hatch a novel plan. One that sidesteps the fight altogether and allows you, despite your meager means, to penetrate

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The Business Owner 1977–2007 Celebrates 30 Years

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From the Editor

David L. Perkins, Jr.

Is it just me, or do you also feel like you're perpetually the little guy, working each day in a land of giants? Everywhere you look, competitors are bigger, more established and have larger budgets.

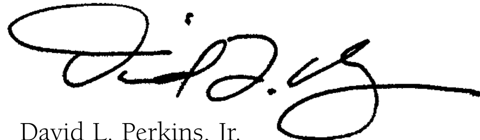
Were they born that way? Am I destined to be the small fry forever? It sure seems that way.

I guess businesses don't change overnight. The small don't become big that quickly. Maybe it's like children growing up. You can't see it happening, but darned if they're not changing.

Maybe we can take comfort in the saying "time heals all wounds." Maybe, with the passage of time, things will work out OK. But, then again, I presume that a lot of businesses never get big. They last a few years, then fade away. Maybe good things happen only through hard work. Nothing good seems to happen around here unless, and until, I work my tail off. Maybe Darwin was right. Maybe it's survival of the fittest. Maybe dinosaurs do fall.

One thing's for sure — I'm not content — and I won't be as long as I'm looking up at giants. This issue provides strategic advice on how to compete against the big dogs — and win.

Sincerely,



David L. Perkins, Jr.
Publisher and Editor

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Competitive Advantage: It's What You Must Develop

It's really pretty simple. You'll grow revenue and increase profit by getting more customers to turn to you and return to you. More customers will turn and return if they get more value from you than they get from your competitors. So, you need to develop a superior ability to deliver value, and you can do this in one of two primary ways:

Cost Leadership — Offering products and services of comparable value but at lower prices.

Differentiation — Offering products of superior value at a price that more than offsets the higher costs that you'll likely incur.

Develop a superior ability to add value to customers and you will have developed a competitive advantage over your competitors. To the victor go the spoils. ❑

> **"Few are those who see with their own eyes and feel with their own hearts."**
>
> *Albert Einstein*

Signs the Big Dog Is Primed for the Picking

Is your biggest competitor ready for a fall? Vulnerable to attack? Michael Porter lists the following signs that a business might be vulnerable. Do you see any of these in your big competitor? If so, the timing might be right for you to devise a novel plan and go after their customers.

Stuck in the Middle. Your competitor is trying to be all things to all people and is not fully satisfying anyone.

Unhappy Buyers. Unhappy buyers suggest that the leader is exercising its bargaining power or that the leader's personnel have developed an attitude of arrogance because of past success. Unhappy buyers may actively encourage and support a challenger.

Pioneer of Current Industry Technology. A leader who pioneered the current generation of industry technology may be reluctant to embrace the next one and may also be inflexible because of its investment in the current technology.

Very High Profitability. A leader making extraordinary profits may provide an umbrella for a challenger, if high profits more than offset the costs of attack. Very profitable leaders can also be reluctant to diminish their profits to retaliate. Moreover, extraordinary returns may also signal that a leader might yield share in less profitable parts of the product line, providing opportunities for focus by challengers.

Weak Performer in the Parent Company Portfolio. A leader perceived as a weak performer by its parent company may not receive the capital needed to keep up with the latest technological change, or have sufficient discretion over profitability to retaliate vigorously against challengers.

From Competitive Advantage *by Michael Porter.* ❑

The Value Chain: Does Yours Help You Compete and Win?

A business is a collection of activities performed to design, produce, market, deliver and support its product or service. The purpose of these activities, of course, is to create value for customers.

Value is delivered to customers by helping them lower costs or raise performance. A company earns a profit if the value created, as evidenced by what buyers are willing to pay, exceeds the cost incurred.

Value Activities

Value activities are the building blocks a company uses to create a product or service. Every value activity involves purchased inputs (material, labor, technology).

There are two broad types of value activities — primary and support. Primary activities include physical creation of the product, its sale and transfer, and its after-sale assistance. Support activities buffer primary activities and each other by providing purchased inputs, technology, and human resources.

How each activity is performed is instrumental to your overall strategy. If your strategy is to become the low-cost provider, then each activity must give you a cost advantage. But if your strategy is to deliver superior product performance to a certain type of customer, then each activity should contribute toward your ability to deliver that value. To compete effectively, you must be unique and offer unique value. By constructing your value chain in a way that differs from your competitors, in ways that are meaningful to your customers, you can deliver a uniquely valuable end-product.

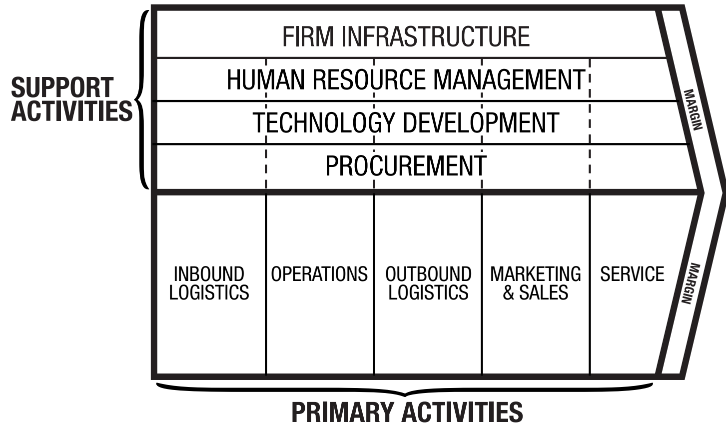
The Value Chain

To fully understand the important component inputs that lead to the delivery of value, a firm must be broken down into its component parts. The process for doing so is called "the value chain."

Construction of the value chain of a business enables a deeper understanding of how value is created and delivered, and illuminates opportunities to improve. Each discrete activity performed by a firm can contribute to its relative cost position and/or create a basis for differentiation. A firm gains an advantage over its competitors by performing these strategically important activities more economically or better than the competition. The accompanying Figure 1 shows a generic value chain.

Starting with the generic chain, identify the individual value activities in your firm. Each generic category can be divided into discrete activities. For example, the marketing and sales category can be divided into marketing management, advertising, sales force administration, sales force operations and technical literature and promotion. Figure 2 on the next page shows a fully completed value chain for a copier manufacturer.

Figure 1. *The Generic Value Chain*



As you construct your chain, attempt to identify the activities that have a high potential impact on differentiation or represent a significantly growing proportion of cost. Also, consider alternatives that could add value or reduce cost.

Buyer's Value Chain

Buyers also have value chains. Your company's product represents a purchased input to your customer's chain. Your differentiation stems from how your own value chain relates to that of your customer. It is a function of the way your physical product is used in the particular customer activity in which it is consumed (e.g., a machine used in the assembly process) as well as all the other points of contact between your business' value chain and your customer's chain.

Differentiation is derived by creating unique value for the customer through your impact on your customer's value chain. Each link between your business and your customer can be used to deliver value. But the links most relevant to a particular customer depend on how the supplier's product is actually used by the customer, not necessarily how it is intended to be used.

The Value System

A company's value chain is imbedded in a larger stream of activities that can be referred to as a "value system," as depicted in Figure 3.

continued on next page

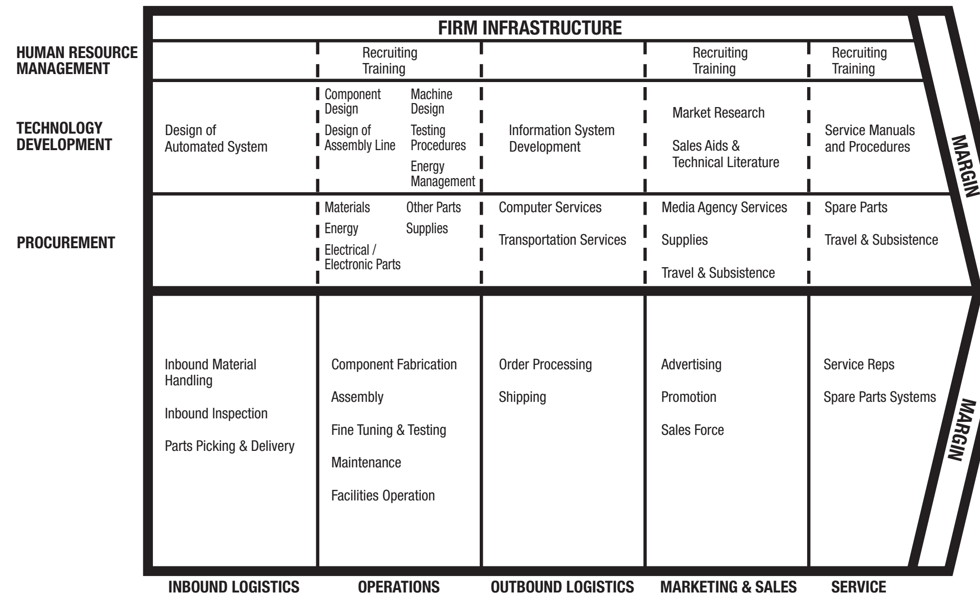
Figure 3. *The Value System*

The Value Chain: Does Yours Help You Compete and Win?, continued from previous page

Suppliers have value chains that create and deliver the purchased inputs used in the customer's value chain. The customer's needs are determined by the customer's own value chain.

Suppliers not only deliver a product but also can influence a customer's performance in many other ways. In addition, a company's products often pass through the value chains of distributors, or resellers (referred to as "channels") on their way

Figure 2. *Value Chain for a Copier Manufacturer*



to the buyer. Channels perform activities that affect the customer and become a part of the customer's own value chain.

The product's role in the end user's value chain ultimately forms the basis for differentiation. Gaining and sustaining competitive advantage depends on understanding not only a firm's value chain but also how the firm fits in the overall value system.

Linkages

Every business' value chain is composed of nine generic categories of activities. Each of these activities is shown on Figure 1 and includes firm infrastructure, human resources management, technology development, procurement, inbound logistics, operations, outbound logistics, marketing and sales, and service.

Each activity is linked together in characteristic ways called "linkages." Although value activities are the building blocks of competitive advantage, the value chain is not a collection of independent activities but a system of interdependent activities. Value activities are related by linkages within the value chain.

Linkages are relationships between the ways one value activity is performed and the cost or performance of another. For example, purchasing high-quality, precut steel sheets can simplify manufacturing, reduce scrap and improve quality. The ability to coordinate linkages often reduces or enhances differentiation. Better coordination, for example, can reduce the amount of total inventory needed throughout the firm. Identifying linkages is a process of searching for ways in which each value activity can be affected or is affected by others.

Use the value chain and value system concepts as a way to break apart your business to more accurately understand how it creates value. By doing so, the business owner can more clearly identify activities that are critical for delivering value to the customer. This also makes it easier to spot areas for improvement. By better understanding the significant impact that vendors/suppliers and distributors/resellers have through linkages, the business owner can more adeptly coordinate relationships in a manner that helps reduce cost, improve performance, and more fully support efforts to deliver unique value. Finally, by applying the value chain methodology to customers, the business owner can pinpoint all the ways that the firm affects the customer — directly and indirectly. Each area offers opportunity to more fully support the business' value-added proposition to the customer. ❑

"I have never known a criminal — terrorist or otherwise — that didn't exaggerate."

Mike Rogers, *United States Congressman*
Chairman of the Homeland Security Subcommittee on Management, Integration, and Oversight

"Don't worry, they're small and nobody recognizes their product. They've got delusions of brand-eur."

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Strategies for Challenging the Market Leader

After studying scores of successful attack plans used by small firms against big dogs, Michael Porter explains that while the strategies have differed widely, there are three avenues of attack:

Reconfiguration: A challenger innovates the way it performs activities in the value chain or in the configuration of the chain. For an explanation of the value chain concept, see the accompanying article entitled "The Value Chain."

Redefinition: A challenger redefines its competitive scope compared to the leader. For an explanation of competitive scope, see the accompanying article entitled "Competitive Scope."

Pure spending: A challenger buys market position through superior resources or greater willingness to invest, which increases the competitive advantage. We will not address this issue here because we assume this strategy is not feasible for you and me.

Each avenue changes the rules of competition to offset a leader's advantages and allows the challenger to gain a cost or differentiation advantage. The avenues are not mutually exclusive, rather are often pursued in tandem. For example, redefining the scope usually requires reconfiguring the value chain. In fact, using more than one of these avenues of attack generally raises the odds of success.

Configuration of the Value Chain

Competitive Scope	Same Chain as Leader	New Activities	Same Chain as Leader
Same as Leader	Spending	Reconfiguration	Reconfiguration
Different from Leader	Redefinition	Reconfiguration and Redefinition	Reconfiguration and Redefinition

As you can see, the avenues of attacking a leader differ along two important dimensions:

Configuration of the Challenger's Value Chain compared to the leader

Competitive Scope of the Challenger compared to the leader (see accompanying article)

A challenger can use the same value chain or one that has reconfigured individual activities or reconfigured the entire chain. At the same time, a challenger may compete with the same scope of activities as the leader or compete with wider or narrower scope.

Pure reconfiguration involves reconfigured activities (within the value chain) or ultimately a significantly different value chain, though with the same scope as the leader. Pure redefinition involves a different scope but the same basic value chain for competing. Reconfiguration and redefinition combine a new chain with a different scope. Pure spending neither reconfigures the value chain nor redefines scope but relies on greater investment by the challenger, leading to a competitive advantage.

Reconfiguration

Reconfiguration allows a challenger to compete differently even though it is competing with the same scope of activities as the leader. The challenger performs individual value activities differently or reconfigures the entire chain to lower cost or enhance differentiation. This strategy creates a cost advantage or differentiation.

For example, Gallo Wines was able to achieve a significant cost advantage through reconfiguring value activities in procurement, blending, bottling, logistics and marketing compared to competitors. In frozen entrees, Stouffer's reconfigured marketing, technology developments, procurements, and broker relations to achieve and sustain differentiation as a "gourmet" product.

The more value activities that can be reconfigured, the greater the possibility that the challenger's competitive advantage over the leader is sustainable. Reconfiguring the entire chain is usually the best advantage against leaders who are highly committed to the traditional industry value chain.

Redefinition

This entails redefining the scope of competition. Broadening scope may provide synergies or advantages that yield a heightened ability to deliver value or lower cost. But narrowing scope can allow a tailoring of the value chain in a way that allows a firm to deliver greater value or lower cost to a narrower customer group.

Evaluate your choice of customer groups, as well as the parts that make up your value chain, in view of your need to compete effectively and deliver superior value to customers. Deliver superior value to customers by providing superior products at a competitive price or competitive products at lower overall cost. ❑

***How to Compete Against the Big Dogs,* continued from cover**

the enemy territory. Develop an innovative plan that wins the battle before it has even begun.

Where do you look to devise such a plan? A good place might be the work of Michael Porter, the undisputed Yoda of strategic theory. He's the author of the globally recognized and studied book *Competitive Advantage: Creating and Sustaining Superior Performance*. Porter says, "Successfully attacking a leader always requires some kind of strategic insight." This starts with a deep understanding of industry, customers, vendors, competitors and products.

Porter studied scores of successful "attacks" that took place in the 1980s:

- Kumatsu's successful attack against Caterpillar (heavy construction equipment)
- Ricoh's successful attack on Xerox (copiers)

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Competitive Scope: Strategically Selecting Your Customers

Competitive scope can have a powerful effect on competitive advantage, because it shapes the configuration and economics of the value chain. There are four dimensions of scope that affect the value chain:

1. **Segment Scope** is the product varieties produced and buyer types served. For example, in the personal computer industry there are two primary types of users — home and business. Home users have a lower need for performance but a much greater need for training, service and user-friendliness. If the big dog on the block serves both, you might be able to gain an advantage by focusing on a single user type. By doing so, you might be able to satisfy the needs of the target customer better than the generalist.
2. **Degree of Integration** is the extent to which activities are performed in-house instead of by independent firms. For example, you may deliver your products using your own trucks and employees, or you may use a contract carrier such as UPS. Your choice may have a great impact to the cost and quality of your product or service. A firm might use one or the other as a strategic means to differentiate itself from a competitor.
3. **Geographic Scope** is the range of communities, regions, or countries in which a firm competes with a coordinated strategy. Geographic interrelationships can enhance competitive advantage if sharing or coordinating value activities lowers costs or enhances differentiation. For example, a bookstore might differentiate itself by researching and stocking foreign titles, winning sales locally as well as across a larger geographic area.
4. **Industry Scope** is the range of related industries in which the firm competes with a coordinated strategy. Similar in concept to geographic interrelationships, synergies can be derived from integrating value activities across industries. For example, a landscape company may operate a retail nursery and an installation company, which increases total volume and increases inventory turnover and utilization of the storage and greenhouse assets. Another example might be Starbucks selling coffee but also selling music CDs, or Disney extending from animated movies to theme parks and retail stores.

Having a broad scope can allow a firm to exploit the benefits of performing more activities internally. It may also allow the firm to exploit interrelationships between the value chains that serve different segments, geographic areas or related industries. But sharing and integration have costs that may outweigh the benefits.

Having a narrow scope can allow the tailoring of the chain to serve a particular target segment, geographic area or industry, to achieve lower cost or to serve the target in a unique way. A narrow scope in integration may also improve the competitive advantage by enabling a firm to purchase or perform better or cheaper.

It is important to note that a firm can pursue the benefits of a broader scope independently, or enter into coalitions with independent firms to achieve some or all of the same benefits. Examples of coalitions include technology licenses, supply agreements, marketing agreements and joint ventures. ❑

***How to Compete Against the Big Dogs,* continued from previous page**

- Timex's successful attack on dominant Swiss watchmakers such as Bulova
- Procter and Gamble's (Charmin) successful attack on Scott Paper (toilet paper)
- Nike's attack on Adidas (sports shoes)
- Gallo's attacks on dominant winemakers

In each case, the challenger succeeded in toppling the entrenched big dog — and become the leader in its target niche.

Porter says "the challenger … must find a different strategy in order to neutralize the leader's natural advantages…" That is, you can't fight the competitor on its terms.

Remember Muhammad Ali? As he had feared, his success led him to a fight against the unbeatable Joe Frazier. How would he defeat Frazier? Joe was a wreckin' machine. Sure, Ali could do what everyone else did: At the sound of the bell, queue up for a beating. Ali wouldn't even lose much respect. After all, who could beat Smokin' Joe?

But Ali wasn't going to give up that easily. He had a dream. But the humbling truth was that Joe was just too strong. Ali would face certain defeat unless he could devise a plan to outwit and outflank.

Sure, Frazier was unbeatable at his toe-to-toe brawl game. But did he have weaknesses? Yes. Did Ali have strengths? Yes. Ali possessed superior speed and had a "reach" advantage. Generally Ali was also considered more intelligent. This is what Michael Porter calls strategic insight. Ali used this insight to hatch his own plan. He controlled his ego, used his quickness to stay outside Frazier's reach, jabbed with greater reach and speed, and when cornered by Frazier, he used "rope-a-dope," a completely new boxing innovation devised by Ali for this fight.

The result? Ali executed his plan perfectly and became "Champion of the World."

Adopt a similar strategy and you can, too.

Five Steps of a Champion

Step 1: Are you willing to accept defeat?

Step 2: Are you willing to face the humbling truth?

Step 3: Can you honestly assess your strengths and weaknesses, and those of your competitor(s)?

Step 4: Can you devise a winning strategy in light of the above?

Step 5: Can you execute your plan? ❑

STRATEGY

Who's on Offense?

Can you imagine a successful football team without an offensive coordinator?

What about your business? Your accountant is a great defensive coordinator, working hard to minimize your tax bill and the chance of an audit. Your attorney is an important defensive strategist, helping you minimize or avoid legal risk and liability. Your insurance agent also is an important defensive player, ensuring that you are protected from financial risk.

So whom do you have on offense? Who's focused on growing the business? Who's helping you think about building long-term value? Just you?

You need positive influence to grow the business. Who's on offense for you?

Ron Dillon, an experienced business broker in Kansas City, makes a strong case for inviting a business broker or mergers and acquisitions (M&A) advisor onto your team. He explains that business brokers see many companies and the prices being paid for each. They see things that add value and make businesses more attractive to buyers. They also see things that detract from value and make businesses less attractive. And whether you want to swell or sell, the goal is the same — to build value.

Find a reputable offensive advisor in your area. Begin with regular breakfast meetings to get to know each other and discuss concepts, share goals, and cover topics such as:

- Where do I want my company to be in the next two, five and ten years?
- What lowers risk and adds value to a business?
- What increases risk and lowers value?
- What do I need to change now to increase value?
- What is the current value of my business and if I sold today, what would I put in my pocket after taxes?
- What risks do I and/or the business bear each day?

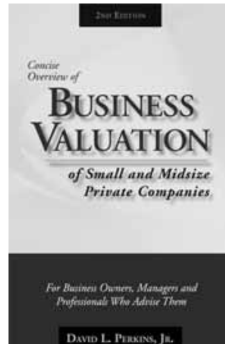
This is basic strategic planning, an offensive game, and it starts with an honest self-assessment.

The next step is to establish a vision and goals, assess the gap and set a plan for bridging it. But you won't get there with defense alone. Sure, a good defense is essential. But to taste sweet victory, you also need a great offense. ❑

This is based on an article by Ron Dillon of Lenexa, Kansas. You can reach him at rondillon@dillon-ma.com

VALUATION

Concise Overview of Business Valuation



A Review by Julio Flavors

Certain concepts are really hard for me to grasp. Infinity. Light. The space-time continuum. Retirement. Business valuation.

As a business owner, I can get by without fully understanding the meaning of "infinity" and "light-year." But "business valuation" might hit home, especially when it comes to understanding "retirement."

None of my college courses taught me how to value my own business. Why? Maybe the professors themselves didn't understand it.

Once I attended a seminar on business valuation. I was interested in the subject and in removing my dark cloud of ignorance. But I was lost. I just sat there critiquing the presenter's style and the quality of listeners' questions — wondering if I was the only one in the dark.

Later, someone told me that the presenters of these seminars really don't want you to "get it" anyway — because then you wouldn't need to hire them. In other words, their whole objective is to convince you that you have no chance of getting it and need to hire them to do it for you.

My frustration turned to complete apathy. Later I was in the bookstore and saw a little book called *A Concise Overview of Business Valuation*; $35 later I wondered if I was on another path to disappointment.

But I was not disappointed. The book is clear and succinct, and offers a commonsense approach to business valuation. Chapter by chapter, Perkins helped me understand basic concepts of business valuation. Although I have no mistaken belief that I can now value a business with confidence, I can honestly say that the dark cloud has lifted.

I also see that I need to work on building value in my own business. After reading the chapter on "Value Drivers," I recognize characteristics of my business that, according to Perkins, drag down value. The good news is that they are things I should be able to change. ❑

INVESTMENT

Too Much Cash in the Bank

If you are holding large amounts of cash in the bank, you're losing money. If you're too busy to mess with it, put the burden on your banker. Call and tell him or her to help you maximize the yield on your cash balances.

For cash that you might need soon, the solution is likely a sweep account. Set it up so that the balances are automatically swept each night into a money market account and invested.

If you are holding cash you won't need for a while, invest it in a manner appropriate for the time horizon. For example, if you're confident that you won't need a certain amount of cash for a year, invest in a one-year certificate of deposit that will provide a higher yield than shorter-term investments. If five years, maybe corporate bonds that yield more than cash, money market and one-year certificates of deposit. If it's more than ten years, consider equities, which have higher volatility but should also offer superior long-term returns.

But as you chase the hard-earned money each day, don't ignore the easy money. ❑

MANAGEMENT

How to Give Constructive Criticism

Constructive criticism in the workplace can be explosive. We say things we don't mean or recipients hear more than was meant. Minor suggestions detonate before our eyes. But skillful communication can make these situations far less volatile.

Respect: The Guiding Principle

Good communication starts with respect or "esteem," as experts say. Great communicators make the recipients of their communication feel they are valuable. Explosions result when we fail to show esteem in all its elements: value, honor and respect.

Here are some explosion-proof tactics to interpersonal success:

1: Stop and Take Personal Inventory

1st-century leader St. James wrote that we should be quick to listen, slow to speak, and slow to become angry. He explains that selfish desires cause quarrels. The first thing we must do is look into our own heart. You may find that the issue is within you, not your adversary.

2: Forgive

Sometimes we act as though the world revolves around us.

Try to change your orientation and choose to forgive. It's a healthy and liberating choice, in effect releasing your foe from owing you anything. It is not easy. It's a decision of will, not feeling. Feelings come and go. Forgiveness is rational, shows humility and projects value and esteem.

3: Listen

King Solomon wrote that speaking before listening is a man's folly and shame. We make Solomon look even wiser by confronting before listening.

The next time you're ready to deliver a double-barreled shot at someone, take a moment to discover the other side of the story. Ask open-ended questions, IN PRIVATE. Never forget, God gave us two ears and only one mouth and we should use them in this ratio.

4: Focus on the Behavior, Not the Person

Instead of saying, "Jim, you're a liar," say, "Jim, you have been lying to me." Rephrasing this may sound trite, but there's a big difference. Then lay out the facts: "Jim, you said that you completed the Seymore job last Friday, but it's still in the shop." Keep in mind that you still should be addressing the person warmly — it's the behavior that's being addressed harshly, not the person.

5: Never When You're Angry

If there's one skill that will keep you out of the interpersonal communication ditch, it's: "Don't communicate when you're angry." Wait till anger has subsided and you'll have a lot more success.

By becoming less self-centered and following a few simple tactics, we can manage encounters in a way that minimizes risk of explosion. ❑

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FINANCE

How to Compare and Analyze Financing Offers

Need more capital? Refinance an existing loan? *The important questions are:* How much *new* money will I get and what will it cost?

To answer those questions, let's review two financing alternatives: an existing loan from a bank and a proposal from a specialty finance company. The finance company has higher advance rates, so it will loan more. The *advance rate* is the percentage a lender uses to determine the amount of money it will loan against certain assets. In our example, the finance company offers advance rates of 90% and 60% against receivables and inventory, respectively, and the bank offers 75% and 25%.

Now let's analyze the two alternatives.

First, the cost:

Bank 8.5%

Finance Company: 10.5%

Which should you choose? To help you decide, let's gather some data. If you were going to borrow only $100,000, the clear choice would be to borrow from the bank. You'd save $2,000 per year:

$100,000 x 8.5% = $8,500 per year

$100,000 x 10.5% = $10,500 per year

But let's say you really need the extra $50,000. What's the cost? Well, we know that the total cost of the $150,000 loan will be:

$150,000 x 10.5% = $15,750

But the cost of the first $100,000 available through the bank is just $8,500, so the incremental cost of the extra $50,000 is $15,750 minus $8,500, or $7,250. This places the extra $50,000 loan at an effective interest rate of 14.5%, calculated as follows:

$7,250 divided by $50,000 = .145 or $14.5%

In theory, if you can put the extra $50,000 to work and earn more than 14.5% (your cost of capital), then go for it. If not, it's a losing situation.

If you plan to use it in your business, the question is: Are you putting in excess of 14.5% on your bottom line? If not, you might want to stick with cheaper forms of financing. ❑

	From Your Bank		From Finance Company	
	Advance Rate	Amount	Advance Rate	Amount
A/R ($100K)	75%	$75,000	90%	$90,000
Inventory ($100K)	25%	25,000	60%	60,000
Total money loaned		$100,000		$150,000

Tax-Sheltered Investment Accounts: Fund Yours Now, Retire Later

Taxes are a huge drain on your wealth. Each time you earn income or realize a gain on an investment, you pay Uncle Sam. One of the only ways to plug the hole is to get investments into tax-sheltered accounts — retirement savings accounts such as an IRA or 401(k). Investments in these accounts accumulate tax-free! The cumulative benefit is substantial. To illustrate, the first table below shows tax-free equivalent annual rates of return. If your investments are in a tax-free account, and your regular overall state and federal tax rate is 35%, you actually earn the equivalent of 12.3% in your tax-sheltered account (an additional 54%!).

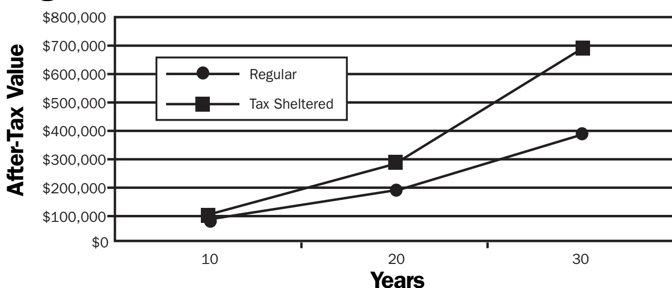
Tax-Free Returns Substantially Higher

Your Overall Tax Rate	Annual Return	Pretax Equivalent*	Bonus Return	Percent Increase
40%	8%	13.3%	5.3%	66%
35%	8%	12.3%	4.3%	54%
30%	8%	11.4%	3.4%	43%

* calculated by the formula 8% / (1- tax rate)

Over time, the impact of this additional rate of return — coupled with the pretax contribution allowance — can be substantial. Let's assume that Sam puts $5,000 of his income (after tax) each year into a regular investment account and earns, on average, 8% per year. Julie forgoes the same annual after-tax amount of salary, but because she is taking advantage of a salary reduction option in a retirement saving plan (and therefore the dollars go into her account pretax), her $5,000 after-tax commitment equals $7,692 on a pretax basis, given that she is in the 35% overall income tax bracket. She also earns 8%, but investment returns in her account compound tax-free. The table below shows the difference in the account balances of Sam and Julie at 10, 20 and 30 years.

Regular Vs. Tax Sheltered



Julie has done little more than take advantage of basic retirement planning options offered by the IRS and used by millions of people, but her savings is **substantially** higher.

It is important to note that the money in Sam's account is tax paid, so he will owe no tax on his funds upon withdrawal. Julie's money will be taxed upon withdrawal at her ordinary income rate, but *we have adjusted her account balance in the table above to show the after-tax value, assuming an overall tax rate of 35%. Julie's actual account balance after 30 years is $1.064 million. The after-tax amount is the $692,000 value used in the table.* ❒

Deciphering the Family and Medical Leave Act

The federal Family and Medical Leave Act (FMLA) can be, at best, baffling to decode and, at worst, grounds for litigation if an employer makes a mistake. Below are some common myths about FMLA and what the law really means for your employees and your business.

Myth: An employee must use his or her FMLA leave in one 12-week "lump sum."

Reality: While family leave taken for the care of a newborn child or placement for adoption must be taken in a "lump sum," unless the employer agrees otherwise, leave taken for an employee's or family member's serious health condition may be taken hourly or through a part-time work schedule when medically necessary and where the need for leave is best accommodated through such scheduling. This is known as intermittent leave or reduced leave schedule. The employer should require certification and documentation from a licensed health care provider substantiating the serious health condition as it would with other types of FMLA leave.

Myth: An employee can take FMLA leave to care for a grandparent, brother or sister.

Reality: FMLA covers only immediate family members: spouses, children, biological parents, stepchildren, foster children, adopted children and those acting as a legal guardian. It does not allow leave to care for siblings, grandparents, aunts or uncles.

Myth: FMLA leave can be taken only for serious conditions such as cancer, inpatient surgery or childbirth.

Reality: If the employee sees a health care provider and is ill or incapacitated for three or more days, that employee can use FMLA time. Under Department of Labor decisions, employees who are out of work even for colds, flu, stomach viruses or migraines would be able to claim FMLA leave if they meet these criteria.

Myth: Managers or supervisors are not responsible for FMLA violations.

Reality: Courts around the country differ on their interpretation of the law. The FMLA's definition of an employer includes anyone who acts in the interest of a company to its employees — directly or indirectly. In some instances, an individual manager has been held responsible for violations.

Myth: An employee taking FMLA leave is guaranteed to get back his or her job — or the equivalent — when he or she returns to work.

Reality: In most cases, this is true. There are some rare exceptions, though: the employee's shift has been eliminated, the employee is a temporary or project employee, the employee is a "key employee" as defined in the FMLA or the employee is terminated with just cause.

As with any other employer regulations, consult with a professional who is well-versed in employment issues to ensure that your business' and employees' rights are protected. By thoroughly complying with FMLA law, you will enhance the well-being of your employees and your company. ❑

This article provided by Administaff (NYSE: ASF; www.administaff.com), a professional employer organization (PEO). Administaff serves as a full-service human resources department for small and medium-size businesses.

Note: Companies with fewer than 50 employees are not required to comply with FMLA!

About the Publisher

David L. Perkins, Jr. owns, writes, edits and publishes *The Business Owner*, the newsletter of choice for more than 35,000 paid business-owner subscribers who are serious about building wealth through successful private business ownership.

Perkins draws editorial ideas and inspiration from his daily work as a merger and acquisitions consultant, where he has advised on more than 100 purchase/sale transactions involving both private and public companies. His M&A consulting firm is Vercor, which has 10 North American offices and a European affiliate. Vercor specializes in sell-side representation of businesses valued between $5 million and $50 million (see www.VercorAdvisor.com).

Perkins holds a BA in psychology from the University of Oklahoma and an MBA from the University of Notre Dame. He has formal training in business valuation. He also pulls editorially from prior experience in commercial real estate leasing and brokerage, commercial bank lending and private company financial management.

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Notebook Computer Theft Is Prevalent Yet Preventable

The advantages of portable technology are undeniable. Notebook computers take the company outside the office and into the action. Unfortunately that's where the risk is.

A laptop is stolen in the U.S. every 53 seconds.

According to Symantec, a laptop is stolen in the U.S. every 53 seconds. Jason Roberts, marketing manager for PC Guardian, says the numbers are increasing 20% per year. Even worse, the FBI reports 98% of stolen computers are never recovered.[1]

Lose one and all sorts of sensitive personal and business data, documents, and emails enter the public domain. A 2006 Ponemon Institute study pegged the average cost of a company laptop theft at $5 million.[2] While we're not sure how Ponemon arrived at such a high number, suffice it to say that protecting oneself and one's company deserves a significant measure of preventive action.

Fair Warning

Awareness is your initial preemptive act. Regular people become victims when they let their guard down.

A momentary step away from your laptop while at Starbucks; conversing with a potential client in a crowded conference room following your presentation; delayed at airport security with your laptop out of sight. These are just a few of the countless scenarios where a lack of awareness and caution invites trouble and inconvenience.

Be warned. Never let your laptop out of your sight!

Secure Your Data and Equipment

Of course, maintaining a regular data backup is a must. You don't want to lose access to your personal or corporate data. But ensuring your access to the data is only half the issue. The other half is keeping it out of someone else's hands.

Encryption technology protects your data. Most encryption services also provide a means for tracing your stolen equipment.

Leading providers of encryption technology include Absolute Software, The CyberAngel and Stealth Signal (www.xtool.com). These companies offer not only exceptional security technology, they are also a source of valuable information on the subject.

Absolute Software (www.absolute.com) touts what it calls Computrace Complete, which is a tamper-resistant software application that, in the event your notebook is stolen, will send you detailed information about any changes made to the information in your notebook.

Laptops and tablets guarded by The CyberAngel (www.thecyberangel.com) benefit from patented technology that silently transmits an alert to the company's Security Monitoring Center, identifying the computer's location.

Biometric devices are gaining popularity. These use fingerprinting, eye patterns and signature styling. These security measures start around $59.

Portability, not Vulnerability

Remember, the loss is preventable, and you can take steps to prevent damage if your laptop is lost or stolen. The starting point is keen awareness. Encryption and tracking cost a little extra but are a business essential, and it's a small price to pay for the benefits and profits of mobility. ❑

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Business Sale by IRC Sec. 338

Every business purchase and sale transaction must be structured as either an asset sale or stock sale. But the method chosen has substantial tax and liability implications for the buyer and seller — in completely opposite directions.

The seller benefits greatly from a stock sale. The buyer wants an asset purchase. This begs the question "Why can't we have it both ways?" Believe it or not, the Internal Revenue Code (IRC) contains a set of laws that allows just that — sort of.

IRC Section 338 allows the seller to sell stock and enjoy the favorable tax attributes of doing so. It also allows the buyer — in the same transaction — to get the desired step-up in basis of the purchased assets (and the attractive depreciation expense enjoyed in the years that follow). This is quite an amazing trick, and mind-blowing for people accustomed to business purchase and sale transactions but unfamiliar with Sec. 338.

But here's the catch:

1. The buyer is responsible for the tax that arises from the step-up in basis of the acquired assets, and
2. Legally, the transaction was effected with stock, so the buyer takes on liabilities of the acquired corporation, including any not known at time of purchase.

You might ask, "How can this be attractive to a buyer when he is paying in full for the step-up in basis **and** assuming all liabilities of the selling corporation?"

Good question. Here's the answer: If certain tax characteristics are present within the entities involved in the deal, the buyer may not actually have to pay the tax bill "out of pocket." So the buyer gets his step-up but owes no tax. For example, if the acquired corporation has net operation loss carry-forwards and tax credit carry-forwards, these tax attributes can be used to offset tax liability created by Sec. 338 election.

Under what conditions might a transaction lend itself to IRC Section 338?

- The corporation being acquired has unused net operating losses, capital losses or tax credit carry-overs.
- The corporation being acquired has assets with a market value that is less than their book value, and the corporation has owed and paid income taxes the past few years. The deemed sale of the depreciated assets may create a taxable loss that can be carried back to obtain a tax refund.
- The corporation being acquired has non-depreciable built-in loss property as well as depreciated built-in gain property. Subsequent to the sale, these gains and losses have the effect of canceling each other out. Additionally, the depreciated property will have a stepped-up basis that will provide a larger depreciation deduction going forward.
- The corporation being acquired is a member of a consolidated return group that has tax attributes to offset the gain and any resulting tax liability from the deemed sale of assets.

If you find yourself involved in a transaction where the company being acquired has tax attributed in some way similar to the above, ask your tax expert if Sec. 338 is right for you. Granted, the buyer will have to get comfortable with taking on liabilities of the purchased company, but assuming this is achievable, Sec. 338 could create a real win-win situation.

IRC Sec. 338 is complex and filled with conditions and provisions. Always consult a tax professional before applying any of these rules. ❑

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It's the Law: Complete I-9 for Every Employee

IRCA requires United States employers to hire only persons who may legally work here: citizens and nationals of the United States and aliens authorized to work. IRCA makes all U.S. employers responsible for verifying the identity and work authorization or eligibility of all employees, whether U.S. citizens or not, hired after November 6, 1986. To implement this, employers are required to complete Employment Eligibility Verification Form I-9 for all employees.

An employer's obligation to review documents is not triggered until a person has been hired, whereupon the new employee is entitled to submit a document or combination of documents of his or her choice to verify his or her identity and work eligibility. In addition, the law obliges employers not to discriminate against individuals on the basis of national origin or citizenship, or to require more or different documents from a particular individual.

The law requires an employer to:

a. Ensure that employees fill out Section 1 of Form I-9 when they start to work.
b. Review documents establishing each employee's identity and eligibility to work.
c. Properly complete Section 2 of Form I-9.
d. Retain Form I-9 for three years after the date the employee begins work or one year after the employee is terminated, whichever is later.
e. Make Form I-9 available for inspection by an officer of the Immigration and Naturalization Service, the Department of Labor, or the Office of Special Counsel for Immigration Related Unfair Employment Practices upon request.

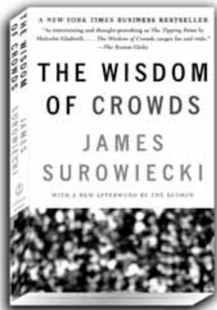
An employer can incur liability under the employer sanctions provisions of IRCA by knowingly hiring an unauthorized alien. It is unlawful for an employer to hire an "alien" knowing that he or she is not authorized to work in the United States. To do so is a "knowing" or "substantive" violation of the law.

continued on page 14

The Wisdom of Crowds

by James Surowiecki

Better decisions lead to better results. But how do we make better decisions?



According to a new book, *The Wisdom of Crowds* by James Surowiecki, the key word is "we." Better decisions often can be made by groups rather than individuals. More particularly, Surowiecki compellingly argues that "under the right circumstances, groups are remarkably intelligent, and are often smarter than the smartest people in them."

Case in point: You've watched *Who Wants to Be a Millionaire*. When the contestant asks the audience, the audience is almost always right. The "smart friends" who are just a phone call away? Not nearly as smart.

Take another case. At a county fair, 800 attendees attempted to guess the weight of a 1,198-pound ox. The average of all 800 guesses was 1,197 pounds. Apparently it was not a fluke.

Under what conditions is a crowd smarter than the smartest person in it? The key is diversity. It adds perspective and works against some of the destructive characteristics of group decision-making. The smaller the group, the more important diversity becomes because, in a small group, it is easy for a few biased individuals to skew the group's decision-making.

And grouping "smart people" together, even if they are diverse, isn't better. People we consider "smart" tend to be homogeneous in the way they think. Adding a few people who know less about the subject but have different skills actually improves the group's performance. According to Surowiecki, "legendary organizational theorist" James G. March says, "The development of knowledge (within a group or organization) may depend on maintaining an influx of the naïve and the ignorant. Competitive victory does not reliably go to the properly educated."

Groups that are too much alike find it harder to keep learning. Nobody is questioning, pushing or introducing new information and perspective.

So, if this is the case, why do we cling so tightly to the idea of the expert? Why do we ignore the fact that simply averaging a group's estimates will consistently produce a very good result? The answer may be that we incorrectly assume that averaging means dumbing down or compromising. We prefer to pick the expert, and we assume that true intelligence must reside in an individual.

I recommend reading *The Wisdom of Crowds*. It's a fascinating book that contends that the key to our success may not be in becoming experts ourselves, or in hiring experts. (Think Enron, they hired the "best and brightest" from top schools.) Instead, it may be in our ability to unlock and trust the collective wisdom of whatever team that happens to be assembled (think Bad News Bears). ❑

STRATEGY

Score Your Company

Ever wonder what a savvy investor might see if he or she looked at your business? Below is a list of criteria that investors would review. Take time to score your company (not yourself). Use 1 for the lowest score and 5 for the highest. Don't worry about an overall score. The goal is to get a picture of strengths and weaknesses — and work on those weaknesses! ❑

1 = lowest possible score (big problem) **5 = highest possible score (no problem)**

		1	2	3	4	5
1	**Customer Concentration**					
2	**Vendor Reliance/Dependence**					
3	**Competition**					
4	**Uniqueness of Your Product**					
5	**Industry Growth**					
6	**Competitive Threats**					
7	**Size of Markets Served**					
8	**Repeat Business**					
9	**Revenue Trend**					
10	**Gross Profit Margin Trend**					
11	**"Bottom Line" Profit Trend**					
12	**Leadership Position in Market**					
13	**Capability of Non-Owner Managers**					
14	**Scalability**					
15	**Brand Awareness/Reputation**					
16	**Sales & Marketing Engine**					
17	**Using Technology**					
18	**Clarity of Vision/Business Plan**					

Marketing Against Big Dogs on a Poodle Budget

"How do I gain an advantage in my market when it seems like all of my competitors can outspend me by at least double or more?"

I hear this from our customers all the time and it's something businesses everywhere struggle with — not just small businesses but any company that is not the leader in its category.

To compete effectively, your marketing needs to be DIFFERENT and BETTER than your competition's. By "better" I don't mean that you need to spend a fortune on your advertising. You just need to reach your audience BETTER than your competition, and you can do that — even on a relatively small marketing budget.

Start by THINKING DIFFERENTLY — how can you market to your target customers or gain publicity DIFFERENTLY than other companies in your industry?

Scoops, a locally owned ice cream parlor in Bloomington, created a stir when it opened its location by sending a press release to celebrities. Scoops was overwhelmed by the response to its release: Celebs sent autographed pictures inscribed with "good luck on your new venture" messages. The walls of the shop are now adorned with framed celebrity photos, providing great buzz for a new, privately owned business.

A small lingerie company in New York didn't have the budget to compete with its big-spending rival, Victoria's Secret. They realized they needed to THINK DIFFERENTLY, so they came up with a crafty marketing campaign. They couldn't afford New York's high media prices, so they stenciled their message (with environmentally safe, washable paints) on sidewalks outside the convention center and other high-traffic areas:

> "From here, it looks like you could use some new underwear."

Risky? Yes. Edgy? You bet. Did it work? Absolutely! Not only did consumers see it, the press noticed it and hundreds of articles were written all over the world about Bamboo Lingerie. You just can't buy publicity like that!

But it's not enough just to "be different." You need to reach your customers BETTER than your competition.

A small bank was looking for ways to attract new customers. It realized that fear of identity theft was having a great impact, with lots of stories in the media, bills before Congress, newspaper articles and television commercials all talking about "identity theft."

The bank capitalized on this ongoing discussion by hosting a "shredding event" at its local branches. Customers were invited to bring in all of their old bank, credit card and utility statements and have them shredded while they watched, protecting their identity while learning about the bank and its services.

The bank partnered with a local office supply company to bring in shredding machines and a local restaurant to cater the event. It issued press releases to newspapers and handed out flyers to its existing customers. Once word got out about the event, the local newspaper and TV station ran stories.

For the cost of a few hundred flyers and a press release, the bank earned tremendous goodwill with the community, got great coverage in the media, and increased its new-customer sign-ups that month more than 50%!

Start thinking today of ways to market DIFFERENTLY and BETTER than your competition, and run with the big dogs — on a poodle-size marketing budget. ❑

Caroline Melberg is president and CEO of Small Business Mavericks, experts in local small-business Internet marketing. You can reach her at SmallBusinessMavericks.com.

I-9, continued from page 12

The I-9 serves two functions:

1. Allows employers to assist the U.S. Citizenship and Immigration Service (USCIS), formerly known as the INS, in enforcing the immigration laws.
2. May be used as evidence against an employer who fails to properly complete and store the I-9 forms, whether or not any of its employees are illegal aliens.

Making the task of ensuring compliance with IRCA more difficult are the non-discrimination provisions found in the act. Under IRCA, employers are liable for any discrimination, whether intentional or inadvertent, that results from an overzealous attempt to comply with the provisions of IRCA. Employers must be especially careful how they render and phrase hiring and termination decisions. Employers who engage in practices or policies that consider the immigration status of a worker may trigger IRCA's anti-discrimination provisions.

In a nutshell, the I-9 process may not be used to pre-screen employees for hiring. Furthermore, an employer may not demand more or different documents than an employee chooses to present, provided that the documents presented are acceptable under the I-9 requirements. Likewise, employers may neither require nor accept more documentation than the minimum necessary to substantiate identity and work eligibility.

As many employers know, there's a two-edged sword with IRCA. You have to ensure that you are hiring properly documented workers — by and through the I-9 process — while at the same time ensuring that the process is not being used to discriminatorily screen out employees. But following proper procedures and policies and maintaining appropriate paperwork will provide employers the tools they need to comply with IRCA and avoid costly fines and/or lawsuits in the future. ❑

Mike Lissau, an employment law expert with Hall Estill, wrote this article. You can reach him at mlissau@hallestill.com.

Scam Alert: GW Equity?

In the January-February 2003 issue of *The Business Owner Journal*, we warned about business brokers:

> *"Beware of persons or companies that represent they can sell your business for a very high value — provided you pay a substantial up-front fee. These companies prey on the hopes, dreams and desperation (at times) of business owners and ask for $8,000 to $40,000 in a single up-front payment — before they have produced anything! They often tout having a pipeline of overseas or foreign buyers — ones you conveniently cannot verify."*

One of the pioneers in this game was Geneva Companies of Irvine, California. Geneva was simply exceptional in its ability to put on the look and feel of a Wall Street investment bank.

Its business model was to mail "we have a buyer for your business" letters to business owners. When business owners responded, they were invited to a daylong seminar that wowed them with superlatives about Geneva's expertise, experience and track record for getting high-value deals done for run-of-the-mill businesses and business owners. At the end, attendees were told they had just this one chance to jump on the money train. The price of the ticket was $40K — just a fraction of the money they were promised they soon would earn. Many paid up.

The bad news is that business owners are people, too, and they don't like to look dumb. They tended not to tell the world when they'd been taken. So scams like these tend to have longer lives then they should. But eventually Geneva was the subject of a class action lawsuit. Although it never admitted guilt, it paid $45 million in settlement and seems to have faded away.

Equico (RSM Equico) was next. Started by the original founder of Geneva Companies, Equico had the same business model. It too seems to have made a ton of money and was very successful. Whether it is still doing its thing, I don't know. Its Web site is still up, but word on the street is that Equico is but a shadow of its former self. Over time, companies like this run out of steam.

GW Equity, headquartered in Dallas, Texas, may be the new kid on the block. Some have said that GW Equity is the reinvention of Great Western Business Brokers, also in Dallas and the subject of a very critical exposé in *Inc*. Magazine (see *For Sale: The American Dream*). Its business model was different from that of Geneva and Equico. Great Western would call business owners and tell them they had a buyer (or buyers) for their businesses. If it could get an appointment, Great Western would send a commission-only sales rep to "sign 'em up." The rep would value the business "on the spot" and, no doubt, value it *very* high — then explain that for, say, $8,000, it would hook up the business owner with a buyer. Of course, almost nothing ever happened except the check clearing the bank.

As one of GW Equity's own reps explains, Great Western Business Brokers "basically ran out of people to screw — so it reinvented itself and changed its name to GW Equity."

With Geneva gone and Equico on the ropes, GW has rebranded itself as a "Wall Street-style investment bank" and has done all the things necessary to display the appearance of credibility. It flashes bios of executives from Fortune 500 companies and with advanced degrees (or better, divinity degrees) from respected schools.

To be sure, GW Equity may not have been "doing its thing" long enough to have gathered victims willing to admit they were fooled. But a recent Internet search found at least one apparent victim. Here's an abbreviated version of his posting:

> *"I was contacted by GW Equity. They assured me that a research team had qualified my company and that they had some investors that were specifically interested in my company. Incidentally, they had two experts that happened to be in my area. I should drop everything and go to a seminar. I did.*
>
> *To take advantage of the opportunity, I needed to pay $29,000. In short, I know now that I was taken. I don't know who to sue, but you bet your backside I am looking into it."*
>
> *Dave*
> *Rockford, Minn.*

Is David in Rockford telling the truth? Is this article factual? You should decide for yourself, but always keep in mind — *if it sounds too good to be true, it probably is.*

Talented and competent business brokers charge up-front fees. But exercise great caution before paying it all in a single check on Day 1.

Disclosure: *The owner, editor and publisher of this publication is David L. Perkins, Jr. He consults on the purchase and sale of businesses. To that end, he could be biased!* ❑

FINANCE

Purchase Contracts: Big Money or Big Mistake?

You've been approached by a vendor to sign an exclusive, long-term purchase contract. Upon execution, they'll cut you a big check. Cash money.

Before you sign, remember what mama always told you, there's no such thing as a free lunch.

Purchase agreements have done a whammy on the quick-lube industry. Just ask industry veteran Michael Baynes. He consults on the purchase, sale and valuation of quick lubes throughout North America. Many people around the industry wish they'd never signed one. The up-front money went quickly and then profit margins suffered for years on end.

Of course, it's possible to get a good deal, but the odds are against it. Before you sign one, have it reviewed by an attorney. Also, compare current prevailing prices, escalation clauses, pass-throughs, inflation adjustments, up-front fees, cancellation fees and penalties. And a pretty accurate crystal ball might help you see where future prices are going. ❑

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