CHAPTER 12

Managing risk like a seasoned entrepreneur means basing decisions on the acceptable downside rather than guesses about a potential upside.

The affordable loss principle: Risk little, fail cheap

IN THIS CHAPTER:

To explore the affordable loss principle, the second principle we see at work in the decision-making approach of expert entrepreneurs, we're going to start with a thought experiment.

Imagine you are an entrepreneur. During your 12-year tenure as an engineer at a major computer manufacturer, you work on your own time to invent a device that recognizes and responds to eye movements. You imagine it might make a great alternative to the computer mouse. You can make it rest on the user's head much like headphones and set it up so that point-and-click navigation is accomplished with even the most minor head and eye movements. You are convinced the device has huge potential. But when you attempt to interest your current company in licensing the idea from you, they don't bite. There are no firms currently offering anything similar to this device, and you possess all the technical skills needed to create the product effectively and efficiently. You quit your job to develop this idea further by, among other things, conducting initial market research on selling the device through the retail channel as an upgrade to existing or new computers. You win a business plan competition and develop a prototype. And then you face a big decision.

A VC who was one of the judges in the business plan competition likes your idea and believes that with an initial investment of US$10 million you could realistically capture 1% of the personal computer market worldwide. She believes your product should sell for US$30 and generate a 20% net profit margin. In return for her investment, the VC would expect to own 40% of your company.

In the meantime, you have been speaking with a friend of your father who runs a large manufacturing facility. He is willing to pay you US$1 million to adapt your technology to create a hands-free device that enables blue-collar factory workers to control industrial manufacturing systems from secure, protected work areas. The adaptation of your product, integration with the factory systems, and commercialization will cost you about US$950,000. He is willing to pay you up front.

CHOOSING THE BEST OPPORTUNITY

Because of the time required to develop these opportunities, you cannot do both simultaneously. You must choose. Here are some questions you might reasonably ask in order to make this decision:

- Which is the bigger opportunity?
- What is the net present value of each opportunity?
- What would you be personally investing into each alternative?
- What is the downside risk of each alternative?

As you look at these questions, you will probably recognize that the first two are the more causal, or predictive ways of thinking about the decision, and the second two are more in line with the logic of effectuation, which we have been discussing in this book. Let us look at each question in turn to get a better grip on what might—and what might not—help you make a good choice between the VC and the father's friend.

Which is the bigger opportunity?

This seems like an obvious question to ask, but how can you possibly know the answer? Take the case of the absurdly unlikely venture 1-800-AUTOPSY, discussed in Chapter 3. Until 1988, the world got along without a company that provided autopsies on demand. However, in light of the growing success of and increasing demand for private autopsy services since the company was founded, one could argue that there was latent demand that simply went unnoticed until Vidal Herrera came along. But if we wind back to 1988, what would his elevator pitch have been to potential investors? Or, for that matter, what would Starbucks' pitch have been in 1980, when US coffee consumption had been declining for 20 years straight?

WHAT GOES INTO MAKING A NET PRESENT VALUE (NPV) PREDICTION?

A lot of forward-looking details. Let's unpack some of them.

Most NPV calculations are anchored with a demand forecast. This typically involves gathering information to form a consensus on the high side and the low side of demand for the product, given certain price assumptions. The price assumptions, similarly, rely on predictions about product features and competitors' actions.

The next step is to estimate the costs it takes to deliver. Costs must be organized into materials and labor, and again according to which are fixed and variable. Each of these costs as well as margins change over time, impacted by your own actions (improving the product or scaling quantities up or down), and your competitors' actions.

Atop those assumptions, you need to discount the cost of capital and assess the variability in the forecast. Put this together, and you can see all the dimensions in NPV that introduce variance and the consequent wide margins of error when forecasting the activity of an uncertain new venture.

Practically Speaking

DELIVERING A VENTURE

It only takes a minute of Steve Kiruri's story to see where entrepreneurial opportunities originate. A recent university graduate in his native Kenya, Kiruri was quick to inventory the things he didn't have: a job, cash or any assets that might be used to secure a loan. Instead, in his own words, "I didn't sit back and moan. I focused on things right there in front of me." These he established to be: his education, relatives asking him to take care of their errands, available space, a government with bureaucratic and time-consuming processes, voluntary labor from high-school graduates and dropouts who were jobless, friends willing to give him a chance and a national media willing to broadcast his story to the world. Transforming this assortment of resources, Kiruri launched a venture called "Petty Errands." His value proposition assured his clients (initially friends and relatives) that he would take care of the small tasks that consume a lot of time because of Kenya's developing infrastructure.

Unplanned route

Instead of a business plan and $5 million in venture capital, Kiruri started right away using what was readily available. And the venture developed as a function of the next resource he added to his list—his clients. Once he had renewed a driver's licence for a client they might ask him if he could pay a bill—a task that can still require a personal visit in Kenya—or courier a package across Nairobi, a chore that could easily cost a morning amid traffic, confusion, and construction. New requests grew into new business opportunities, and Petty Errands became more than a petty business.

Next stop

That was 1995. Since then, the firm has added corporations, non-governmental organizations (NGOs), and government bodies to its client base. Petty Errands is licensed by the Communication Commission of Kenya (CCK) as an Intra-City Operator, and Steve has been recognized as the "Most Inspiring Business Person" by Kenya Television Networks. Today, the firm employs more than 50 people and handles over 15,000 "errands" in a year. But Steve's story isn't over, and neither is the story of where opportunities originate. Because today, Steve's list of things to work with is much longer than it was in 1995. In addition to certifications, clients, and

Mr Steve Kiruri, in blue jacket, of Petty Errands at his firm's offices.

Practically Speaking *(continued)*

employees, he has also added things such as a respected brand, knowledge of the current needs (and issues) of clients, operations and motorcycle transportation expertise, extensive contacts within the Kenya courier industry, and good relations with bankers. Indeed, the story of creating opportunities is one that starts again and again as new resources are found, acquired, used and lost through business activity, meeting new people and learning new skills. Similarly, Steve's own story is still very much in the writing.

Expanding the path

As Petty Errands becomes a business of scale, new opportunities abound. Should Steve take his expertise with the light motorcycles the firm uses for its couriers to offer service, spare parts or leasing of the machines to the general public? Could Steve advance into the cargo business, taking advantage of his operational knowledge to better serve his client base? Or might Steve best create ways to fully use his resources, such as delivering wedding or event invitations on Saturdays when the errand business is slow? These businesses have yet to appear, but the insight into the source of opportunity is already here. Taking what is readily available and transforming what are seemingly mundane resources into something valuable is the ongoing errand of the committed entrepreneur.

Common sense suggests that while you might be able to calculate what you could lose by investing in a venture (namely, everything that you put into it), it is much harder to calculate the potential upside—that is, the size of the opportunity.

What is the net present value of each opportunity?

Just because calculating the upside of an opportunity is difficult doesn't mean people don't try. Net present value (NPV) is a formula widely used in the business world to predict the current value of a future project. To calculate the NPV of your two options, you'll need to answer several questions: What is your forecasted demand? What is your product cost? What are your overheads? How will these costs change over time?

Put this together, and you can see the interrelated system of prediction involved in trying to assess the value of an opportunity. And you can also see how, as the assumptions accumulate, the calculation becomes much closer to guesswork than science.

What would you be personally investing into each alternative?

Both options, the one from the VC and the one from your father's friend, require you to invest a variety of resources. Spend a moment thinking about how the options differ in terms of the following:

- Your time commitment.
- Your reputation.
- Your opportunity cost.
- Your knowledge.
- Your emotional commitment.
- How would you measure these? How would you decide what constitutes an appropriate level of investment? These are highly subjective and personal assessments that change over time, just as tangible costs do.
- What is the downside risk of each alternative?

Let's assume you choose the venture capital option. Here are some possible scenarios:

ASSESSING AFFORDABLE LOSS

	Venture Capitalist	My Father's Friend
Time		
Reputation		
Opportunity Cost		
Knowledge		

- The market is not there, and the VC pulls the plug on the company.
- The market is there, but the VC takes control of the firm and fires you.
- You don't get along with the VC, but you can't buy her out.
- The market ends up being 25,000 units per year, just enough to break even, but leaving you managing a firm turned into the "living dead."

Now, assuming you have decided to work with your father's friend, consider these scenarios:

- You miss a critical deadline that costs your father's friend a week's manufacturing output. Your father's friend is unhappy with your father.
- You deliver something defective, and an employee is hurt as a result.
- It costs you twice as much to implement the solution as you estimated.
- While you are working with your father's friend, a new company releases a product very similar to yours, and it is a runaway success.

For each option, which scenario is the worst and why? Which scenarios are within your control? Which are not? What do you do next in each case?

Starting by organizing the issues in this way is the first step in assessing "affordable loss."

Affordable loss and its use as a decision tool

NPV offers useful projections in situations where the information that goes into the calculation is relatively stable. Managers in mature markets ranging from energy to carbonated soda make frequent use of NPV. But in the uncertain setting of new venture creation, the information necessary to perform an NPV calculation is either unavailable, or the ranges are so broad that results are not helpful in planning or running a new venture.

The research upon which this book is based suggests that instead of trying to calculate the upside of an opportunity, using NPV, expert entrepreneurs take what we call an "affordable loss" approach. Fundamentally, affordable loss is based on things they know and can control, whereas NPV is based on predictions they don't trust and can't control.

Like the other principles of effectuation, affordable loss turns traditional business practice on its head. Instead of deciding whether to pursue an opportunity based on potential returns, effectual entrepreneurs look at potential

To ponder

A loser doesn't know what he'll do if he loses, but talks about what he'll do if he wins.

A winner doesn't talk about what he'll do if he wins, but knows what he'll do if he loses.

Eric Berne

losses. They base their decisions on what downside risk they find acceptable rather than on what they guess the upsides might be. So instead of calculating up front how much money they need to launch their project and then investing time, effort, and energy into raising that money, effectual entrepreneurs determine what they are willing to lose. As they pursue the opportunity, they bring stakeholders on board, reducing resources the entrepreneur and the stakeholders need to commit to the venture and better controlling risks through the effort, commitment, and resources of self-selected stakeholders.

As we walk through how to think in terms of affordable loss, the important point to remember is that affordable loss puts the entrepreneur front and center. Traditional business planning puts the venture front and center, asking what financing the venture needs to get off the ground independent of the entrepreneur's available means. Affordable loss starts with the entrepreneur's concrete situation, not abstract estimates of venture financing needs. As such, the emphasis is on taking the entrepreneur's context into account. Big decisions like taking the plunge into entrepreneurship depend a lot on your family, your stage of life, and the social norms around you —for example, attitudes toward failure in your community and industry.

To figure out your affordable loss, you must consider your life situation, current commitments, aspirations, and risk propensity. It is helpful to think of this as a two-step process.

The first step is to ask how much you really need to start your business—the less you need, the less you need to worry about losing. You can greatly reduce your upfront cash needs by getting creative about different ways of bringing your idea to market using all the means that are available to you. The vast majority of new businesses are started with small sums of money, and rely heavily on nonfinancial contributions, such as the entrepreneur's time and (often) family support as well as slack resources from partners.

Research Roots

MENTAL ACCOUNTING

The notion of mental accounting was first developed in a paper by Thaler (1985: 199) and later summarized in another of his papers (Thaler, 1999). Mental accounting emerges fairly straightforwardly from the idea of bounded rationality: creatures with limited cognitive processing capabilities (human beings, that is) require ways of keeping track of their money. Thaler theorized that people do so by categorizing their resources, as accountants do. For example, they create separate mental compartments for long-term savings (such as retirement and children's education) and short-term expenses (such as entertainment and leisure activities). A key implication of mental accounting is the violation of the fungibility premise of economics—i.e. that resources are automatically arbitraged across accounts (Thaler, 1999: 183). A simple way to think about this is that for Homo economicus, "Money by any other name is still money" but for most Homo sapiens, "Money in one mental account is simply not the same as money in another account." Because of this non-fungibility characteristic, mental accounting suggests that consumers may borrow at high interest rates in some accounts even while they save at much lower interest rates in others.

Practically Speaking

OPPORTUNITY IN THE TRASH

Academics in general, and economists in particular, are not known for their sense of humor. However, there is an old joke about an economist strolling down the street with an entrepreneur when they come upon a £50 note on the ground. As the entrepreneur reaches down to pick it up, the economist says, "Don't bother—if it was a real £50 note, someone would have already picked it up." The entrepreneur shrugs his shoulders, puts the bill in his pocket and says, "You're right—someone just did."

But seriously . . .

The entrepreneur in the joke is probably Brooke Farrell. The £50 note? Not exactly real currency, but likely more valuable. It's trash. Farrell spent eight years consulting to US waste conglomerate Waste Management, and saw how many £50 notes cross the kerbside every day. "You look around and you see waste absolutely everywhere," she says. "If you loaded the annual waste generated by the US into trucks, the convoy necessary to carry it all would circle the equator of the earth 600 times. But look around again. What you're seeing are opportunities. Everywhere."

Matchmaker

In 2009, Farrell quit her job and, together with her brother-in-law, co-founded a firm called RecycleMatch. The idea was an online exchange where firms trade trash. From a recycling perspective, it is a natural recombination of her experience in the waste business with his software expertise creating business-to-business marketplaces. But having a good match in the founding team does not guarantee the same with the clients.

Moneymaker

The pair self-funded the venture on the shoestring they were willing to invest and spent the first six months creating a prototype they could show potential clients. Most executives in large firms do not spend their days looking for a market for their waste, so Farrell went looking for them. The first was a large international corporation with 180,000 pounds of window glass that had been damaged in a hurricane. Covered in a thick

How it works

1 Sellers posts waste or recyclables
- Company is confidential
- Specify conditions & requirements
- Invite buyers you know to bid

For Sellers

2 Buyers bid on materials
- Receive alerts on new materials
- Buyers can ask questions of sellers
- Consider reputation of sellers when making offers

For Buyers

3 A Match is made
- Escrow service protects both buyers and sellers
- Save money and the environment
- Materials stay in closed loop system instead of landfill

For Pricing

Practically Speaking *(continued)*

plastic coating, the glass was deemed unrecyclable and was headed for a landfill. "We told them we could make them money listing their material on our marketplace," says Farrell. "We thought we were offering upside, but actually they signed with us because they had nothing to lose. Our service is confidential, and we don't get paid unless the market clears. We found another company that wanted to crush the glass and 'upcycle' it into countertops. The market was born."

A market for the market

RecycleMatch launched in February 2011. Already, the firm has enabled trading of waste polyester from paint roller production to an automobile manufacturer, and consumer product returns from an interior decorator to a textile producer that upcycles the unwanted upholstery. It has attracted outside investors and a seasoned CEO. Farrell, not one to let an opportunity go to waste, is already working on a new offering from RecycleMatch. In addition to the public marketplace where any company can list waste and bid on it, she is creating an enterprise product—software that helps large companies and supply chains manage, track, and monetize waste streams and industrial by-products across their distributed locations. "I would go to a big firm, and tell them what we are doing," she says. "They would tell me it's fantastic, but that their trash isn't like that. It took me a little while, but what I realized they were saying is that they have absolutely no idea what they waste. We're going to give them the information they need about themselves to be more sustainable and make more money." Apart from showing how business can do good for the world, the lesson is where opportunities originate. It isn't the theories from the economist, or the inevitability of the market. It is the dirty hands of the entrepreneur who picks up £50 notes.

The second step is to ask what you are really able and willing to lose to start your business. This means taking an inventory of your available resources and gauging your risk tolerance.

DECIDING ON YOUR AFFORDABLE LOSS: SOME GUIDELINES

Once you have gone through the process of doing everything possible to lower the amount of money you need to get your venture off the ground, you are left with the question of what downside risk is acceptable to you. Here, the key thing is to ask yourself the right questions. It's helpful to think through both what you can afford to lose and what you are willing to lose. We'll look at each of these in turn.

Different kinds of losses

People "mentally account" for different resources in different ways. For example, many individuals are willing to invest loads of time in a new business but carefully limit how much cash they put into it. Evidently, people account for their time differently than they account for their cash. Similarly, some resources are mentally accounted for in ways that preclude them from being put at risk. A good example is savings that parents accumulate to fund their children's education. These monies are often considered "out of bounds" for risking on a new business venture.

To figure out what you can afford to lose, you have to know what your resources are, and you have to make some decisions about what belongs in the category of "riskable" and what doesn't. As you are thinking about this, remember that some psychologists have argued that

DETERMINING AN ACCEPTABLE LEVEL OF RED INK IN THE NEWSPAPER INDUSTRY

Consider the launch of the USA Today newspaper. The newspaper's owners did substantial financial analysis on the launch decision. But all the analysis did not change the fact that the paper's success was critically dependent on advertising revenues (70% of the revenue base), which were driven by the reactions of several key competitors to the new paper—that is, the success or failure of the venture hinged in part on the interaction between the different actors in the marketplace. However good the analysis that went into the launch decision, the paper's financial future couldn't be controlled by its owners—it was in the hands of its competitors.

USA Today was launched in 1982. It was estimated to have lost US$400 million in its first five years, and continued to lose money for its first decade. It reported its first year of profits (US$7.5 million) in 1993.

rational people never put at risk what is truly valuable to them.

Consider the following categories of resources as you think through what you can afford to lose and what is "out of bounds" for you.

Time

The time entrepreneurs put into a new venture is often referred to as "sweat equity." A good proportion of entrepreneurs sweat it out over long periods. However, this may make sense to them because time is a different "currency" from cash and, therefore, it is often accounted for in a different way. Moreover, because time is perishable, people feel differently about contributing it—after all, they might have wasted it anyway. Therefore, you may be able to afford losing time more than you can afford losing money.

Windfalls

As Fred Smith was creating the business plan for FedEx, his father died, leaving US$8 million to Fred and his sister—money that was used to fund the new company. This seems like a rather high level of affordable loss, but it's not surprising. Many people put inherited money into a different mental account than earned income—they are willing to risk the former but not the latter. Other kinds of windfalls that can significantly increase an individual's affordable loss are lottery winnings and big upswings in the value of assets such as stock.

> You can't always control the wind, but you can control your sails.
>
> Anthony Robbins

In retrospect, Fred Smith's decision to invest his and his sister's inheritance into the fledgling FedEx looks prescient. But had he been a seasoned entrepreneur, he might have first tried to start the firm with US$0 of his own money.

Long-term savings

Research suggests that most people apply rules of thumb to borrowing against or spending certain resources that are mentally accounted for as belonging to other parts of their life. Examples include funds set aside for their own retirement and for the care of dependents, e.g. children and parents.

Practically Speaking

PARTNERS' AFFORDABLE LOSS

It would be fair to say that Marius Tudosiei was longer on aspiration than more tangible resources. Growing up in the northern part of Romania, his childhood was spent in and around a big kitchen, where traditional food was cooked using fresh and natural ingredients. But when Marius arrived in the capital city of Bucharest, the availability of such artisanal cuisine was very limited. So in 2009, Marius quit his job in the media industry to build "something dedicated to good food"—though he had no idea what that something might ultimately look like, and no capital to fund the project.

Aspiration to action

So he started with what was available and free. He built a Facebook page and asked his friends to tell him about food and about what his business should be. Soon, he had 1,000 friends advising him to open a restaurant. But he said no. Not enough money, not enough expertise. Instead, he decided to offer his friends good food from his small network of suppliers—opening a small and highly specialized grocery store as a means of distribution.

Action to interaction

Though less expensive to start than a restaurant, a grocery store still required capital Marius didn't have. Until a mentor asked him how much he needed. "10,000 euro," he replied, "and I do not have any idea where I could get that much money." To which the mentor responded, "But do you have 10 friends to give you 1,000 euro each?" Before he was done, he had raised a total of 25,000 euro in small bits and pieces from a number of friends.

Interaction to creation

Marius founded Bacania Veche (The Old Grocery Store) in 2010 and it is already one of the most popular small food enterprises in Romania dedicated to good and healthy food. From that starting point he has gone on to open a restaurant (which is also a Charity Shop for Hospice), and a TV cooking show. He delivers food daily for 200 children in five nurseries, has a corporate catering business, and employs 20 people.

Secret ingredient

There is no way to get the recipes which generated this comment on Tripadvisor: "It is the greatest shop that I have ever seen. Cookies and bread cooked on the spot give the flavour and enchant the visitor." But the secret that enabled Marius to get going is understanding his partners' affordable loss. While an investment of 10,000 euro is a meaningful sum for many individuals, providing 1,000 euro to a friend starting the business changes the proposition. If the business fails, losing 1,000 euro is not a crushing loss. But if the business is successful, the 1,000 euro will return a profit and perhaps all sorts of other benefits. A good recipe for bringing people into a venture.

The family home/home equity

There are many instances in which people use home equity loans to fund a business startup. However, some individuals are unwilling to put their home at risk, as the loss would not be "affordable."

Credit cards

We've all heard stories about companies initially financed on credit cards—EDS and Home Depot come to mind.

There is some evidence that people mentally account for credit card expenses differently from other expenses because credit cards weaken the link between making the decision to purchase something and actually paying for it.

Loans from family and friends

Other examples of weak links between purchasing and paying may include loans from family members that have flexible or unspecified payback terms. Descriptions of family business, for example, refer to the relatives' money as "patient capital." Such funds may seem more affordable to use and to lose than funds with heavy pressure to repay at specific deadlines.

What am I willing to lose?

Once you have decided what you can afford to lose in general, you still need to decide what you are willing to lose on this particular venture. Figuring this out will mean assessing the degree and intensity of your desire to start this particular venture. It will also mean creating thresholds, since if the downside case for your venture hits a key threshold you have set, this will dictate your course of action. Ultimately, the question you have to ask yourself is, "Is the venture worth doing even if I lose what I invest?"

Regardless of whether your motivation to become an entrepreneur is largely pecuniary or non-pecuniary, there are several ways reasoning through the plunge decision using the idea of affordable loss is likely to increase the chances that you'll decide to go ahead:

- It reduces the financial risk. Going through the exercise of minimizing startup costs lowers the risk of starting your venture.
- It allows you to focus on things within your control (the downside loss) and proceed in spite of things outside your control, which increases your confidence.
- It makes explicit that the upside potential for the venture is in large part contingent on your actions and the actions of your stakeholders,

"We've considered every potential risk except the risks of avoiding all risks."

Research Roots

AFFORDABLE LOSS

The economist George Shackle refers to the concept of affordable loss in a paper in which he postulates that the entrepreneur might characterize each venture opportunity according to the possible gains and possible losses and suggests that the latter can help the entrepreneur evaluate which opportunity to pursue.

> It is practical and reasonable to regard the focus-loss, in absolute terms, as depending on the nature and scale of the enterprise concerned. Thus, by choice of an appropriate kind, or an appropriate size, of plant or enterprise, he can adjust the greatest amount he stands to lose, that is, his focus loss, to the amount which, given the size and character of his assets, he can afford to lose.
>
> (Shackle, 1966: 765)

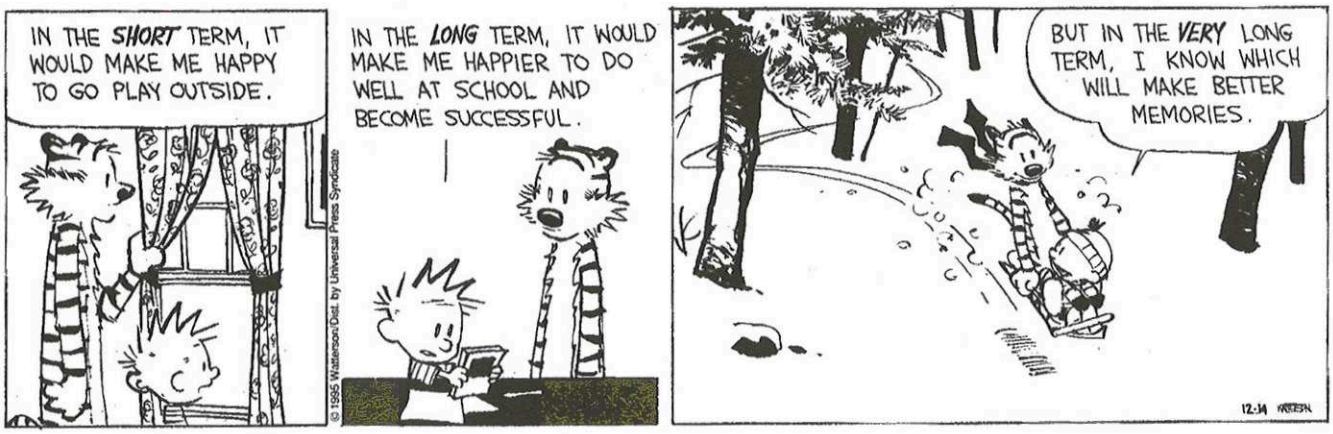
which again increases the perceived controllability of the venture and, therefore, its attractiveness.

- It encourages you to consider an opportunity from the perspective of what matters to you in ways beyond the economic upside. Bringing in factors that lie beyond financial calculation makes the decision more realistic, and in tune with how most people actually make major decisions.

In short, using the principle of affordable loss will provide you with more reasons for taking the plunge into entrepreneurship and fewer reasons for saying no.

TAKEAWAY: UN-RISKY BUSINESS

Statistics would seem to suggest that budding entrepreneurs would have a bias against starting new ventures, simply because a large number of new firms fail. Affordable loss lessens the impact of failure—it makes failure clearly survivable by constraining the loss to something the entrepreneur is in fact willing to lose in order to pursue the venture. If the entrepreneur reduces the downside risk to an acceptable level, he or she is likely to lose less in the event of failure than an entrepreneur who invests based on his or her guess about the venture's upside potential.



So What?

Using affordable loss to reason through the plunge decision helps you see how to get started right now, while managing your risk. The decision to start a business doesn't have to be about predicting whether the upside is big enough; instead, it can be about whether the downside is "life threatening."

What Now?

For the opportunity you are developing, work these through from the perspective of affordable loss:

- ☐ Do I hire at all? Whom specifically should I hire? How should I hire them?
- ☐ How much, if any, do I invest in longer-term investments such as research and development?
- ☐ Can I quantify the levels of time, reputation, money, and other resources I am willing to lose to advance my idea to the next step?
- ☐ Who benefits from my idea, and how can I bring them on board to share the expense and risk as well as the benefit?

Think It Through

- ☐ How do notions of affordable loss differ in different parts of the world?
- ☐ How might affordable loss encourage or discourage commitment?
- ☐ If investment in an opportunity is constrained by affordable loss, can it lead to a "homerun"?