

Starting a Small Business: The Feasibility Analysis

by Michael D. Reilly, Ph.D. and Norman L. Millikin, Ph.D.
College of Business, Montana State University-Bozeman

Healthy local economies stem from the formation of new businesses. Unfortunately, the success rates for small businesses are typically quite low. Depending on which statistics you believe, the chances of a new business surviving for five years are between 30 and 50 percent.

As an entrepreneur, you can greatly increase your chances for success by analyzing your idea, your marketplace and your management team before beginning.

The Feasibility Analysis

Whether you plan to expand an existing business, acquire an existing business or start your own new business, this MontGuide will show you how to perform a basic **economic feasibility analysis**: a preliminary evaluation of your business idea to see if it's worth pursuing.

In performing your feasibility analysis, you will:

- Evaluate whether you and your management team possess the characteristics most common to entrepreneurial success;

- Assess the market for your new business idea;

- Estimate the basic financial feasibility of your business, including potential sales revenues, fixed and variable costs, and break-even figures;

- Identify the pitfalls many new small businesses encounter—and study how you can avoid them; and

- Finally, make an informed choice about whether or not your idea is still attractive and practical.

Characteristics of Successful Entrepreneurs

Studies show that the personalities and individual characteristics of the entrepreneurs who start new businesses may be the most important factors of success.

An individual's management skills have become so important that venture capitalists have begun to revise the way they look at potential new venture deals. Rather than betting on the "horse" (i.e., the business idea and the business plan), they are now much more likely to bet on the "jockey" and look for someone who has a his-

tory of successful past entrepreneurial efforts. These investors have come to realize that a good business plan does not necessarily make a good business, but a good entrepreneur *can*, whether the business plan is optimal or not.

Your management team—or the one you will assemble—is also extremely important. Compare the key players in your potential business to the ideals described on page 2 of this guide and see how many of these characteristics they possess. Obviously, no one will display all of the qualities, but this worksheet can still help you assess your potential for success as an entrepreneur.



Characteristics of Successful Entrepreneurs—Checklist

Check off the degree to which each characteristic on the list describes you and your management team.

V = Very much like me (us), S = Somewhat like me (us), N = Not like me (us) at all.

Successful entrepreneurs typically:

Are decisive decision makers.

Entrepreneurs tend to make decisions early and instinctively and are often forced to rely on their judgement and make decisions without complete information. If you agonize over decisions, this is not you.

V S N

Enjoy taking charge.

Successful entrepreneurs enjoy taking charge and following through to the end. Entrepreneurs are good at finishing projects, getting closure as well as grabbing them from the start.

V S N

Want to be master of their financial destiny.

Entrepreneurs typically have less desire to get rich as to “do their own thing” and prove they are right. In fact, entrepreneurs usually make less money than they would working for someone else. Their real income is psychic income, the satisfaction that comes from doing what they know is right.

V S N

Are organized, independent and self-confident.

Entrepreneurs usually have few people to rely on. They must be able to perform all the different parts of their business alone.

V S N

Are hard workers.

People who start small businesses usually work longer, harder and more stressful hours than people who work for someone else, largely because entrepreneurs have no one to fall back on.

V S N

Come from a small business or agricultural background.

Entrepreneurs who have been involved in small family businesses have a better chance at success. They are generally able to recognize the characteristics and sacrifices required by small business people, and know what they are getting into from the start.

V S N

Can take criticism and rejection.

An entrepreneur must be able to take criticism and rejection and bounce back with a positive aspect. If you turn off at the first sign of trouble, you are probably not the kind of person who will be successful in a small business.

V S N

Have specialized business ability from experience or education.

Individuals who enter a business with which they are familiar, either by education or experience, have a higher success probability.

V S N

Are determined and persistent.

Successful entrepreneurs typically go where angels fear to tread. They must be able to successfully avoid nagging doubts and “keep on keepin’ on.”

V S N

Can find people to shore-up weakness. Are good judges of talent and character.

Typically, an entrepreneur’s major problems are people. It is necessary to assemble a group of people who make up for the talents you lack.

V S N

Can see how all the parts fit together.

As the owner of a small business, you have to wear many hats: finance, marketing, accounting, bookkeeping, human relations and more. It is necessary to see how these different pieces fit together to form the entirety of the business.

V S N

Look at your responses to the questions on characteristics. If you circled “very much like me (us)” for the majority, you probably have the skills to succeed in small business. If you circled “not like me at all” for the majority of these qualities, you may lack the characteristics needed for success in a small business.

Your characteristics and those of your team are only one part of the feasibility analysis of a small business. Your next step is to determine whether or not a market exists for your business idea.

Market Assessment

Assessing the market size for a new business is a tricky but critical part of a feasibility analysis. For a business idea to work, you must have enough customers willing to spend enough money on your product or service to provide sales revenue that covers your expenses and, hopefully, earns you a profit. Accordingly, determining how many potential customers exist might be an essential part of discovering whether your business idea is going to work.

The first thing consumers usually do when they hear of a new product or service is compare it to existing alternatives. Customers will buy from a new business only if they perceive the value provided by that new business to be greater than the value provided by existing competitors.

Perceived value is a judgement. Consumers compare what they *think* they are going to get from your new business to what they *think* they are getting from existing businesses. To attract them, you must convince them that you are providing something better, more convenient, healthier, more durable, cheaper, or of a higher

quality at the same price. In short, you must create a perception that you have a competitive advantage.

This advantage can be based on many different characteristics: location, a specific product line, technology or exclusive access to some supplier. No matter what it is, there must be something about your business that makes it distinctive, different and competitively superior to the businesses your customers will compare you to.

Next, determine whether or not you can communicate your competitive advantage simply and believably to the marketplace. It is not enough just to be better—you have to convince potential customers that you are better.

Begin with a little market research, the process of discovering what makes a specific market work. Typical questions answered in a preliminary market research study might include:

- How many customers are there? Who are they, and what are they like?
- How many service or product providers are there already?
- How does each compete?
- What do they say about each other?
- How successful are they?
- What does it take to succeed in this business?

These are all questions that must be answered, or at least understood, before launching a new business venture. Know who you are competing against and why you can persuade customers to frequent *your* business instead of those currently operating.

One of the key success factors in a small business is having the resources to wait out the inertia of your customers. Customers are creatures of habit and, therefore,

unlikely to change their behavior immediately just because a new product or service enters the marketplace.

Frequently, it takes a long time for people to become familiar and comfortable enough with a new business to patronize it. In fact, many studies show that it takes three years for a new small business to break even and five years to begin making a profit. Most business plans, though, are considerably more optimistic. Some entrepreneurs like to say, “It took us five years to become an overnight success.”

Financial Feasibility

Your next step is to decide whether your business is financially feasible.

First, estimate the sales or revenue that your business will generate. Use these three general principles:

- Don’t count on promises. Many people begin their market survey by asking potential customers, “If I opened this business, would you buy from me?” The responses are then added to generate an estimate of potential sales.

Problem: It is much easier for consumers to answer “yes” to a hypothetical question than it is to actually change their behavior and buy a new product from a new business. Business owners who estimate sales on the promises in a questionnaire frequently discover that the market is much smaller than they thought.

- Be conservative. Underestimate your potential sales, as it is always easier to adjust your costs for a higher-than-expected level of sales than it is to control your costs when your sales estimate is too high.

- Make a range of sales esti-

mates. Estimate your potential sales in a number of ways and compare figures. Try two or more of the following methods and see how different the results are. Be conservative and pick the smallest estimate of the group, or be aggressive and take an average.

Sales Estimation Methods Industry or Association Data

Industries and associations of retailers, wholesalers and other businesses often keep good industry-specific statistics on the performance of individual outlets. Use these to estimate the sales of your potential new business. Look in the library for the "Encyclopedia of Associations." Contact people at the organization of businesses similar to yours and ask for data that might help you estimate sales.

Market Potential/Market Share

Determine the potential of the market (i.e., the total of all sales in the product or service category in which you will compete).

For example, to estimate the potential sales of a video store, get some industry data on national video rental sales per person (or get a total United States video rental revenue and divide by the country's 250 million population). Multiply the per capita figure by the number of people in your market area for an estimate of market potential.

Next, calculate your share of the market. To begin, estimate your share as equal to that of your smallest competitor, or estimate your share as equalling the average competitor in the market. In any case, be sure not to assume you will take over the market, particularly in the short run.

Customer Counts

The next method of estimating sales for a new business is based on the number of customers you will have. Calculate the total number of customers in your market area, identify how many of those you think you can attract, and multiply that number by their average expenditure per year.

Obviously, the difficult part is determining how many of those customers you can attract. Think of such factors as your location and number of competitors.

Similar Business in Similar Location

One of the most reliable ways to estimate sales performance of a new business is to look for similar enterprises in similar areas.

For example, if you are trying to estimate the sales of a new mall retail store, look at retail stores that sell a similar product in other malls. Get their sales as a percentage of total mall sales.

Then, figure out what the total sales are for your mall, and calculate your percentage of that. This may be the most reliable of all the methods, because it allows you to accurately gauge how you might perform based on similar performances by competitors.

Indicator Variable

Retail stores sometimes measure their potential sales in terms of sales per square foot. They get industry average sales per square foot, and then determine the number of square feet of retail space they are going to have.

Sales of Existing Competitors

Look at your competitors in the marketplace and estimate their sales. Sit outside and keep track of the number of people coming out with bags. This will give you an

estimate of customer numbers.

Then, figure the average expenditure of each customer, multiply the two together and get an idea of your competitors' sales. This might serve as a reasonable estimate for your own business.

In any case, you must begin your own estimate of economic feasibility for your business with a good, conservative estimate of your anticipated sales.

Costs and Break-Even

The next step is to estimate your costs, which is often much easier than estimating sales. Divide your costs into two basic categories: fixed and variable. **Fixed costs** are expenses that do not vary with the level of your sales, such as rent, manager's salary, utilities, insurance and other operating expenses.

Variable expenses are directly related to sales, and include items such as raw materials or purchases to be sold, and direct labor.

Next, calculate your **break-even**, the sales level at which your business has neither a profit nor a loss. When you compare your break-even to your estimated sales, you'll have a rough idea whether or not your business is financially feasible.

As you estimate break-even, you'll use quantities that describe the relationship between your prices and your variable costs: your **contribution margin** and your **contribution percentage** (explained below). If you are selling a relatively small number of items with a fixed dollar amount of cost (i.e., manufacturers), compute the contribution margin. If you are selling a wide variety of items with a standard mark-up percentage (i.e., retail stores), work with the contribution percentage.

Review these examples:

Example 1: Toy Manufacturer

If you were to make toys that sell for \$5 each and your variable costs (most likely materials and labor) average \$3 per toy, your contribution margin is:

$$\begin{aligned}\text{Contribution Margin} &= \text{Price} - \text{Variable Cost} \\ &= \$5 - \$3 \\ &= \$2\end{aligned}$$

Now, bring in your fixed costs. Say, for example, your fixed costs as a toy manufacturer are \$50,000.

$$\begin{aligned}\text{Break-even} &= \frac{\text{Total Fixed Costs}}{\text{Contribution Margin}} \\ &= \$50,000 / \$2 \\ &= 25,000 \text{ units}\end{aligned}$$

Thus, you would need to sell 25,000 toys to break even. More importantly, the break-even number indicates how much you'd make or lose at any sales level. If you sell more or less than your break-even, your profit or loss will equal the contribution margin multiplied by the difference between actual sales and break-even.

For example, if you sold only 20,000 toys, your loss would be \$10,000 (5,000 x \$2). Sales of 35,000 toys would give you a \$20,000 profit (10,000 x \$2).

Example 2: Clothing Store

The break-even calculation works a little differently when a wide variety of items are sold, all with approximately the same percentage mark-up. Consider these hypothetical fixed monthly expense for a clothing store:

Rent	\$500
Telephone	\$150
Travel	\$200
Advertising	\$200
Employees	\$600
Miscellaneous	\$100
Total	\$1,750

If your gross margin is 40 percent (i.e., you buy items for \$60 and sell them for \$100), then your break-even is calculated as follows:

Break-even

$$\begin{aligned}\text{Sales in Dollars} &= \frac{\text{Total Fixed Costs}}{\text{Gross Margin \%}} \\ &= \$1,750 / .40 \\ &= \$4,375 \text{ per month}\end{aligned}$$

Estimating break-even allows you to determine your necessary sales per day, per month and per year. Then you can compare that with realistic estimates of the sales you might expect. Knowing what it takes to break even can give you an idea of whether or not you have a potentially feasible business idea.

Potential Pitfalls

If your market assessment and financial analysis lead you to believe that your new business idea has potential, you next need to

avoid the pitfalls that frequently capture the unwary small business person.

Often the most serious involve an incomplete understanding of the financial implications of a small business. Get a good accountant and take his or her advice.

Beginners often underestimate the amount of money needed to begin, and they do not allow for working capital, (i.e., the money you need to finance your inventory and maybe your finished product between the time you buy it as raw

materials, pay the laborers to assemble it, ship it to the destination and finally get paid.) Most people try to borrow the minimum amount of money possible and forget about working capital. If you borrow short term, you may eliminate your ability to generate working capital.

The second major pitfall is not sticking to the plan. You will have to make many tough decisions for your small business: personnel and sales do not materialize as expected; the market changes in some way; or something else hap-

pens that makes your fundamental scenario infeasible. You need to be flexible and carefully plan ahead—particularly in terms of cash management. If sales change, you need the courage to change your cost structure to keep pace. It is better to have your cost chasing your revenue than your revenue chasing your costs.

Beginning business people frequently underestimate the impact of taxes and benefits, particularly for employees. A person who makes \$5 per hour is actually going to cost you about \$7 per hour once you count in unemployment, worker's compensation, social security and any benefits.

Finally, and most significantly, most studies of failed businesses reveal one of two patterns: either the business fails because of lack of customers (i.e., a gross overestimate of the market) or, alternatively and maybe more horrifyingly, a business can fail because the market was much *greater* than anticipated.

Small businesses with very high growth rates have tremendous cash flow problems. If your business doubles in one year, most people think that would be the best thing that could happen. But in truth, if your business has a profit margin around five to ten percent, you might discover you are not generating enough money from the doubled sales to maintain the necessary inventory for that high level of sales.

This can lead to cash flow problems, inability to meet payroll, sloppy production and service, and a variety of the problems that can ultimately destroy your business. You must carefully manage growth. Grow slowly, or make sure that you can finance growth so that it will not harm your business.

Summary

Individuals who start small businesses generally work harder for less money but are happier than their counterparts who work for someone else. If you would

like to start a small business, you must thoroughly and objectively analyze the feasibility of your idea. Failure to do so can have a tremendous personal cost on finances, relationships and family ties.

Lots of information is available on how to start a small business, and many public agencies are currently assisting small business people with these decisions. Get the help you need and use it.

For Further Information

Contact economic development organizations in your area, such as:

- Local chamber of commerce
 - SCORE (Senior Corps of Retired Executives)
- or try:
- Small Business Administration, 449-5381
 - Montana Entrepreneurship Center, 994-2024
 - Montana Department of Commerce, 444-3757.



The programs of the MSU Extension Service are available to all people regardless of race, creed, color, sex, disability or national origin. Issued in furtherance of cooperative extension work in agriculture and home economics, acts of May 8 and June 30, 1914, in cooperation with the U.S. Department of Agriculture, Andrea Pagenkopf, Vice Provost and Director, Extension Service, Montana State University, Bozeman, Montana 59717.

File under: Community Development
E-13 (Economic Development)
Reprinted August 1996 (1162000895 SG)