

The Entrepreneurial Spectrum

INTRODUCTION

The 1990s could be called the original “entrepreneurship generation.”¹ Never before had the entrepreneurial spirit been as strong, in America and abroad, as it was during that decade. More than 600,000 new businesses were created at the beginning of the 1990s, with each subsequent year breaking the record of the previous one for start-ups.² By 1997, entrepreneurs were starting a record 885,000 new businesses a year—that’s more than 2,400 a day. This astonishing increase in new companies was more than 4 times the number of firms created in the 1960s, and more than 16 times as many as during the 1950s, when 200,000 and 50,000, respectively, were being created each year.³ This unprecedented growth in entrepreneurial activity was evidenced across all industries, including manufacturing, retail, real estate, and various technology industries. This decade was also an “equal opportunity” time, as the entrepreneurial euphoria of the 1990s was shared by both genders and across all ethnicities and races. I’ve always believed that the beauty of entrepreneurship is that it is color-blind and gender-neutral.

New evidence indicates that this 1990s generation of entrepreneurs may actually be surpassed in upcoming years by the members of “Generation Y,” or those born between the years 1977 and 1994. This should come as no surprise when one considers that this group grew up during entrepreneurship’s golden age and later saw its parents laid off or downsized out of “lifetime” corporate

jobs. Generation Y has also spent most of its life and virtually all of its postsecondary years in a digital age, where technology has significantly reduced the barriers of entry for start-ups. The members of Generation Y, who may have seen VHS tapes and record albums only at neighborhood garage sales or museums, are now enrolling in college entrepreneurship classes at a rate that is roughly seven times what it was just six years ago. Jeff Cornwall, the entrepreneurial chair at Belmont University in Nashville, characterizes Generation Y's increase in entrepreneurial interest well: "Forty percent or more of students who come into our undergraduate entrepreneurship program as freshmen already have a business. It's a whole new world."⁴

ENTREPRENEURIAL FINANCE

In a recent survey of business owners, the functional area they cited as being the one in which they had the weakest skill was the area of financial management—accounting, bookkeeping, the raising of capital, and the daily management of cash flow. Interestingly, these business owners also indicated that they spent most of their time on finance-related activities. Unfortunately, the findings of this survey are an accurate portrayal of most entrepreneurs—they are comfortable with the day-to-day operation of their businesses and with the marketing and sales of their products or services, but they are very uncomfortable with the financial management of their companies. Entrepreneurs cannot afford this discomfort. They must realize that financial management is not as difficult as it is made out to be. It must be used and embraced because it is one of the key factors for entrepreneurial success.

This book targets prospective and existing "high-growth" entrepreneurs who are not financial managers. Its objective is to be a user-friendly book that will provide these entrepreneurs with an understanding of the fundamentals of financial management and analysis that will enable them to better manage the financial resources of their business and create economic value. However, the book is not a course in corporate finance. Rather, entrepreneurial finance is more integrative, including the analysis of qualitative issues such as marketing, sales, personnel management, and strategic planning. The questions that will be answered will include:

What financial tools can be used to manage the cash flow of the business efficiently? Why is valuation important? What is the value of the company? Finally, how, where, and when can financial resources be acquired to finance the business?

Before we immerse ourselves in the financial aspects of entrepreneurship, let us look at the general subject of entrepreneurship.

TYPES OF ENTREPRENEURS

There are essentially two kinds of entrepreneurs: the “mom-and-pop” entrepreneur, a.k.a. the “lifestyle” entrepreneur, and the “high-growth” entrepreneur.⁵

The Lifestyle Entrepreneur

Lifestyle entrepreneurs are those entrepreneurs who are primarily looking for their business to provide them with a decent standard of living. They are not focused on growth; rather, they run their business almost haphazardly, with minimal or no systems in place. They do not necessarily have any strategic plans regarding the growth and future of their business and gladly accept whatever the business produces. Their objective is to manage the business so that it remains small and provides them with enough income to maintain a certain, typically middle-class, lifestyle. For example, Sue Yellin, a small-business consultant, says she is determined to remain a one-person show, earning just enough money to live comfortably and “feed my cat Fancy Feasts.”⁶

While they may have started out as lifestyle entrepreneurs, some owners ultimately become, voluntarily or involuntarily, high-growth entrepreneurs because their business grows despite their original intention. For example, the *Inc.* magazine 500 is composed of 500 successful high-growth entrepreneurs. When a survey was taken of these entrepreneurs, their answers for the completion of the statement, “My original goals when I started the company . . .” suggest that almost 20 percent were originally lifestyle entrepreneurs, given the following responses:

- Company to grow as fast as possible: 50.9 percent.
- Company to grow slowly: 29.4 percent.

- Start small and stay small: 5.8 percent.
- No plan at all: 13.8 percent.⁷

Finally, one of the most prominent stories of a lifestyle entrepreneur turned high-growth entrepreneur is that of Ewing Marion Kauffman, who started his pharmaceutical company, Marion Laboratories, in 1957 with the objective of “just making a living” for his family. He ultimately grew the firm to over \$5 billion in annual revenues by 1986, creating wealth for himself (he sold the company in 1989 for over \$5 billion) and for 300 employees, who became millionaires.⁸

The High-Growth Entrepreneur

The high-growth entrepreneur, on the other hand, is proactively looking to grow annual revenues and profits exponentially. This type of entrepreneur has a plan that is reviewed and revised regularly, and the business is run according to this plan. Unlike the lifestyle entrepreneur, the high-growth entrepreneur runs the business with the expectation that it will grow exponentially, with the by-product being the creation of wealth for himself, his investors, and possibly his employees. One of the best stories of high-growth entrepreneurship is Google, which will be discussed in greater detail later. The high-growth entrepreneur understands that a successful business is one that has basic business systems—financial management, cash flow planning, strategic planning, marketing, and so on—in place. *Inc.* magazine surveyed a group of entrepreneurs who were identified as “changing the face of American Business” and found that these entrepreneurs were high-growth entrepreneurs, demonstrated by the fact that not only were they millionaires, but they grew their firms from median sales of \$146,000 with 4.5 employees to median sales of \$11 million with 219 employees. These data also show that these entrepreneurs grew their companies efficiently, since their sales per employee increased from \$32,444 to \$50,228, a 55 percent improvement.

Wilson Harrell, a former entrepreneur and current *Inc.* magazine columnist, did a fantastic job of describing the difference between these two types of entrepreneurs. The first description is that of a lifestyle entrepreneur:

Let's say a man buys a dry cleaning shop. He goes to work at 7 a.m. At 7 p.m. he comes home, kisses the wife, grabs the kids, and goes off to a school play. At his office you'll see plaques all over the walls: Chamber of Commerce, Rotary Club, the local Republican or Democratic club. He's a pillar of the community, and everybody loves him, even the bankers.

Change the scenario. After the man buys the dry cleaning shop, he goes home and tells his wife, "Dear, we're going to mortgage this house, borrow money from everyone we can, including your mother and maybe even your brother, and hock everything else, because I'm about to buy another dry cleaner. Then I'll hock the first to buy another, and then another, because I'm going to be the biggest dry cleaner in this city, this state, this nation!"⁹

The second scenario obviously describes the life of a high-growth entrepreneur who has the long-term plan of dominating the national dry cleaning industry by acquiring competitors, first locally and then nationally. His financing plan is to leverage the assets of the cleaners to obtain commercial debt from traditional sources such as banks, combined with "angel" financing from relatives.

Unfortunately, not all entrepreneurs who seek high growth can attain it. Sometimes circumstances outside of their control can hamper their growth plans. For example, one entrepreneur in Maine complained that he could not grow his business because of labor shortages in the region. He said, "I'm disgusted by the labor situation around here. People don't want to get ahead. It adds up to businesses staying small."¹⁰

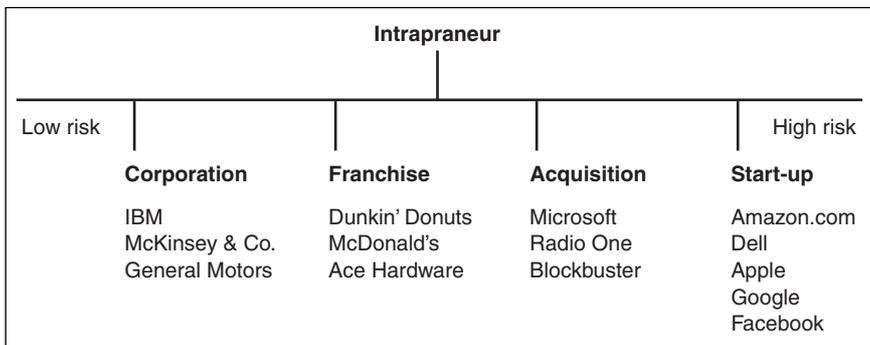
THE ENTREPRENEURIAL SPECTRUM

When most people think of the term *entrepreneur*, they envision someone who starts a company from scratch. This is a major misconception. As the entrepreneurial spectrum in Figure 1-1 shows, the tent of entrepreneurship is broader and more inclusive. It includes not only those who start companies from scratch (i.e., start-up entrepreneurs), but also those people who acquired an established company through inheritance or a buyout (i.e., acquirers). The entrepreneurship tent also includes franchisors as well as franchisee. Finally, it also includes *intrapreneurs*, or corporate

entrepreneurs. These are people who are gainfully employed at a Fortune 500 company and are proactively engaged in entrepreneurial activities in that setting. Chapter 13 is devoted to the topic of intrapreneurship. But be it via acquisition or start-up, each entrepreneurial process involves differing levels of business risk, as highlighted in Figure 1-1.

FIGURE 1-1

The Entrepreneurial Spectrum



The Corporation

While the major Fortune 500 corporations, such as IBM, are not entrepreneurial ventures, IBM and others are included on the spectrum simply as a business point of reference. Until the early 1980s, IBM epitomized corporate America: a huge, bureaucratic, and conservative multibillion-dollar company where employees were practically guaranteed lifetime employment. Although IBM became less conservative under the leadership of Louis Gerstner, the first non-IBM-trained CEO of the company, it has always represented the antithesis of entrepreneurship, with its “Hail to IBM” corporate anthem, white shirts, dark suits, and policies forbidding smoking and drinking on the job and strongly discouraging them off the job.¹¹ In addition to the IBM profile, another great example of the antithesis of entrepreneurship was a statement made by a good friend, Lyle Logan, an executive at Northern Trust Corporation, a Fortune 500 company, who proudly said, “Steve, I have never attempted to pass myself off as an entrepreneur. I do not have a

single entrepreneurial bone in my body. I am very happy as a corporate executive." As can be seen, the business risk associated with an established company like IBM is low. Such companies have a long history of profitable success and, more importantly, have extremely large cash reserves on hand.

The Franchise

Franchising accounts for 40 percent of all retail sales in the United States, employs over 18 million people and accounts for roughly \$1.5 trillion in economic output.¹² Like a big, sturdy tree that continues to grow branches, a well-run franchise can spawn hundreds of entrepreneurs. The founder of a franchise—the franchisor—is a start-up entrepreneur, such as Bill Rosenberg, who founded Dunkin' Donuts in the 1950s and now has approximately 7,400 stores in 30 countries.¹³ These guys sell enough donuts in a year to circle the globe . . . twice! Rosenberg's franchisees (more than 5,500 in the United States alone¹⁴), who own and operate individual franchises, are also entrepreneurs. They take risks, operate their businesses expecting to gain a profit, and, like other entrepreneurs, can have cash flow problems. The country's first franchisees were a network of salesmen who in the 1850s paid the Singer Sewing Machine Company for the right to sell the newly patented machine in different regions of the country. The franchise system ultimately became popular as franchisees began operating in the auto, oil, and food industries. Today, it's estimated that a new franchise outlet opens somewhere in the United States every 8 minutes.¹⁵

Franchisees are business owners who put their capital at risk and can go out of business if they do not generate enough profits to remain solvent.¹⁶ By one estimate, there are over 750,000 individual franchise business units in America,¹⁷ of which 10,000 are home-based. The average initial investment in a franchise, not including real estate, is approximately \$250,000.¹⁸ Examples include Mel Farr, the owner of five auto dealerships. Farr's auto group is just 1 of 15 subsidiaries in his business empire—valued at more than \$573 million. Another such entrepreneur is Valerie Daniels-Carter, the founder of a holding company that manages 70 Pizza Hut and 36 Burger King restaurants that total over \$85 million in combined annual revenue.¹⁹ Additional data from the International Franchise Association and the U.S. Department of Commerce, given in

TABLE 1-1**Growth in Franchises in the United States (Selected Years)**

Year	Number of Franchises	Annual Revenues of Franchises (Billions of Dollars)
1970	396,000	120
1980	442,000	336
1990	533,000	716
1992	558,000	803
2001	767,483	
2005	909,253	

Source: U.S. Department of Commerce; International Franchise Association.

Table 1-1, shows that the number of franchised establishments is continually and rapidly growing and has more than doubled since 1970.

Because a franchise is typically a turnkey operation, its business risk is significantly lower than that of a start-up. The success rate of franchisees is between 80 and 97 percent, according to research by Arthur Andersen and Co., which found that only 3 percent of franchises had gone out of business five years after starting their business. Another study undertaken by Arthur Andersen found that of all franchises opened between 1987 and 1997, 85 percent still operated with their original owner, 11 percent had new owners, and 4 percent had closed. The International Franchise Association reports that 70 percent of franchisors charge an initial fee of \$30,000 or less.²⁰

Max Cooper is one of the largest McDonald's franchisees in North America, with 45 restaurants in Alabama. He stated his reasoning for becoming a franchisee entrepreneur as follows:

You buy into a franchise because it's successful. The basics have been developed and you're buying the reputation. As with any company, to be a success in franchising, you have to have that burning desire. If you don't have it, don't do it. It isn't easy.²¹

The Acquisition

An acquirer is an entrepreneur who inherits or buys an existing business. This list includes Howard Schultz, who acquired Starbucks

Coffee in 1987 for approximately \$4 million when it had only 6 stores. Today, more than 40 million customers a week line up for their caffe mochas, cappuccinos, and caramel macchiatos in 12,400 Starbucks locations in 37 countries. Annual revenues top \$7.8 billion, and, according to the company's SEC filings, the ownership team opened 2,199 new Starbucks outlets in the year 2006 alone!²²

The list of successful acquirers also includes folks like Jim McCann, who purchased the almost bankrupt 1-800-Flowers in 1983, turned it around, and grew annual revenues to \$782 million by 2006.²³ Another successful entrepreneur who falls into this category is Cathy Hughes, who over the past 27 years has purchased 71 radio stations that presently generate \$371 million in annual revenues, making her broadcasting company, Radio One (NYSE), the seventh largest in the nation. The 51 stations have a combined value of \$2 billion.²⁴

One of the most prominent entrepreneurs who fall into this category is Wayne Huizenga, *Inc.* magazine's 1996 Entrepreneur of the Year and Ernst & Young's 2005 World Entrepreneur of the Year. His reputation as a great entrepreneur comes partially from the fact that he is one of the few people in the United States to have ever owned three multibillion-dollar businesses. Like Richard Dreyfuss's character in the movie *Down and Out in Beverly Hills*, a millionaire who owned a clothes hanger-manufacturing company, Wayne Huizenga is living proof that an entrepreneur does not have to be in a glamorous industry to be successful. His success came from buying businesses in the low- or no-tech, unglamorous industries of garbage, burglar alarms, videos, sports, hotels, and used cars.

He has never started a business from scratch. His strategy has been to dominate an industry by buying as many of the companies in the industry as he could as quickly as possible and consolidating them. This strategy is known as the "roll-up," "platform," or "poof" strategy—starting and growing a company through industry consolidation. (While the term *roll-up* is self-explanatory, the other two terms may need brief explanations. The term *platform* comes from the act of buying a large company in an industry to serve as the platform for adding other companies. The term *poof* comes from the idea that as an acquirer, one day the entrepreneur has no businesses and the next, "poof"—like magic—he or she purchases a company and is in business. Then "poof" again, and the

company grows exponentially via additional acquisitions.) As Jim Blosser, one of Huizenga's executives, noted, "Wayne doesn't like start-ups. Let someone else do the R&D. He'd prefer to pay a little more for a concept that has demonstrated some success and may just need help in capital and management."²⁵

Huizenga's entrepreneurial career began in 1961 when he purchased his first company, Southern Sanitation Company, in Florida. The company's assets were a garbage truck and a \$500-a-month truck route, which he worked personally, rising at 2:30 a.m. every day. This company ultimately became the multibillion-dollar Waste Management Inc., which Huizenga had grown nationally through aggressive acquisitions. In one nine-month period, Waste Management bought 100 smaller companies across the country. In ten years the company grew from \$5 million a year to annual profits of \$106.5 million on nearly \$1 billion in revenues. In four more years, revenue doubled again.²⁶

Huizenga then exited this business and went into the video rental business by purchasing the entire Blockbuster Video franchise for \$32 million in 1984, after having been unable to purchase the Blockbuster franchise for the state of Florida because the state's territorial rights had already been sold to other entrepreneurs before Huizenga made his offer. When he acquired Blockbuster Video, it had 8 corporate and 11 franchise stores nationally. The franchisor was generating \$7 million annually through direct rentals from the 8 stores, plus franchise fees and royalties from the 11 franchised stores.²⁷ Under Huizenga, who didn't even own a VCR at the time, Blockbuster flourished. For the next seven years, through internal growth and acquisitions, Blockbuster averaged a new store opening every 17 hours, resulting in its becoming larger than its next 550 competitors combined. Over this period of time, the price of its stock increased 4,100 percent: someone who had invested \$25,000 in Blockbuster stock in 1984 would have found that seven years later that investment would be worth \$1.1 million, and an investment of \$1 million in 1984 would have turned into \$41 million during this time period. In January 1994, Huizenga sold Blockbuster Video, which had grown to 4,300 stores in 23 countries, to Viacom for \$8.5 billion.

Huizenga has pursued the same roll-up strategy in the auto business by rapidly buying as many dealerships as he possibly can

and bundling them together under the AutoNation brand. By 2001, AutoNation was the largest automobile retailer in the United States, a title it still holds in 2008. By the way, if you ever find yourself behind the wheel of a National or Alamo rental car, you're also driving one of Wayne's vehicles—both companies are among his holdings. What Huizenga eventually hopes to do is to have an entire life cycle for a car. In other words, he buys cars from the manufacturer, sells some of them as new, leases or rents the balance, and later sells the rented cars as used.

Huizenga also owns or previously owned practically every professional sports franchise in Florida, including the National Football League's Miami Dolphins, the National Hockey League's Florida Panthers, and Major League Baseball's Florida Marlins. He never owned the National Basketball League's Miami Heat; his cousin did.

Now, here's your bonus points question—the one I always ask my Kellogg students. What's the common theme among all of Huizenga's various businesses—videos, waste, sports, and automobiles? Each one of them involves the rental of products, generating significant, predictable, and, perhaps most importantly, *recurring* revenues. The video business rents the same video over and over again, and the car rental business rents the same car a multitude of times. In waste management, he rented the trash containers. But what's being rented in the sports business? He rents the seats in the stadiums and arenas that he owns. Other businesses that are in the seat rental business are airlines, movie theaters, public transportation, and universities!

Another example of an acquirer is Bill Gates, the founder of Microsoft. The company's initial success came from an operating system called MS-DOS, which was originally owned by a company called Seattle Computer Products. In 1980, IBM was looking for an operating system. After hearing about Bill Gates, who had dropped out of Harvard to start Microsoft in 1975 with his friend Paul Allen, the IBM representatives went to Albuquerque, New Mexico, where Gates and Allen were, to see if Gates could provide them with the operating system they needed. At the time, Microsoft's product was a version of the programming language BASIC for the Altair 8800, arguably the world's first personal computer. BASIC had been invented in 1964 by John Kenney and Thomas Kurtz.²⁸ As he

did not have an operating system, Gates recommended that IBM contact another company called Digital Research. Gary Kildall, the owner of Digital Research, was absent when the IBM representatives visited, and his staff refused to sign a nondisclosure statement with IBM without his consent, so the representatives went back to Gates to see if he could recommend someone else. True opportunistic entrepreneur that he is, Gates told them that he had an operating system to provide to them and finalized a deal with IBM. Once he had done so, he went out and bought the operating system, Q-DOS, from Seattle Computer Products for \$50,000 and customized it for IBM's first PC, which was introduced in August 1981. The rest is entrepreneurial history. So Bill Gates, one of the world's wealthiest people, with a personal net worth in excess of \$50 billion, achieved his initial entrepreneurial success as an acquirer and has continued on this path ever since. Despite its court battles, Microsoft continues to grow, investing hundreds of millions of dollars each year to acquire technologies and companies. Over the last three years, Microsoft has spent more than \$3 billion on acquisitions.²⁹ Don't worry, however—there's still some spare change in the Microsoft couch. In June 2007, Microsoft had \$23.4 billion in cash on its books.³⁰ In October 2007, Microsoft paid \$240 million for 1.6 percent of the online social network Facebook, which was founded three years earlier.

The Start-Up

Creating a company from nothing other than an idea for a product or service is the most difficult and risky way to be a successful entrepreneur. Two great examples of start-up entrepreneurs are Steve Wozniak, a college dropout, and Steve Jobs of Apple Computer. As an engineer at Hewlett-Packard, Wozniak approached the company with an idea for a small personal computer. The company did not take him seriously and rejected his idea; this decision turned out to be one of the greatest intrapreneurial blunders in history. With \$1,300 of his own money, Wozniak and his friend Steve Jobs launched Apple Computer from his parents' garage.

The Apple Computer start-up is a great example of a start-up that was successful because of the revolutionary technological

innovation created by the technology genius Wozniak. Other entrepreneurial firms that were successful as a result of technological innovations include Amazon.com, founded by Jeff Bezos; Google, with Harry Page and Sergey Brin; and Facebook, with Mark Zuckerberg.

But entrepreneurial start-up opportunities in the technology industry do not have to be limited to those who create new technology. For example, Dell Computer, one of the largest computer systems companies in the world, with \$61 billion in annual revenues in 2008,³¹ is not now, and never has been, a research and development-driven company, unlike the companies previously mentioned. Michael Dell, the founder, got his entrepreneurial opportunity from the implementation of the simple idea that he could “out-execute” his competitors. He has always built computers to customer orders and sold them directly to consumers at prices lower than those of his competitors. As he explained, “I saw that you’d buy a PC for about \$3000 and inside that PC was about \$600 worth of parts. IBM would buy most of these parts from other companies, assemble them, and sell the computer to a dealer for \$2000. Then the dealer, who knew very little about selling or supporting computers, would sell it for \$3000, which was even more outrageous.”³²

Michael Dell, who dropped out of the University of Texas and founded his company in 1984 with a \$1,000 loan from his parents, went on to become in 1992, at age 27, the youngest CEO of a Fortune 500 company. Less than 10 years later, Dell had revenues of more than \$15 billion in just the first six months of 2001, and its founder topped the *Forbes* “40 richest under 40” list. Today, Dell is ranked number 43 on the *Forbes* list of the world’s billionaires, with a net worth in excess of \$16 billion.³³

Entrepreneurial start-ups have not been limited to technology companies. In 1993, Kate Spade quit her job as the accessories editor for *Mademoiselle* and, with her husband, Andy, started her own women’s handbag company called Kate Spade, Inc. Her bags, a combination of whimsy and function, have scored big returns on the initial \$35,000 investment from Andy’s 401(k). In 1999, sales had doubled to \$50 million. Neiman Marcus purchased a 56 percent stake in February 1999 for \$33.6 million.³⁴ And in 2006, revenues reached \$84 million.

Finally, there are also numerous successful start-ups that began from an idea other than the entrepreneur's. For example, Mario and Cheryl Tricoci are the owners of a \$40 million international day spa company headquartered in Chicago called Mario Tricoci's. In 1986, after returning from a vacation at a premier spa outside the United States, they noticed that there were virtually no day spas in the country, only those with weeklong stay requirements. Therefore, they started their day spa company, based on the ideas and styles they had seen during their international travels.³⁵

NOTES

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