

Recessions and Entrepreneurship

Is necessity the mother of invention?

BY DAVID VAN DEN BERG

In 1986, at the age of 29, Gary Erickson started a wholesale bakery called Kali's Sweets & Savories. The bakery made Greek calzones and cookies, and sold them to specialty food retailers in the San Francisco Bay area. By 1991, the company had 10 employees and was generating more than \$300,000 in annual sales, but failed to break even. Erickson was working nights and driving the delivery truck on Tuesdays and Fridays, and working at a bicycle company by day.



During the 1990-1991 recession, Erickson started Clif Bar, an organic nutrition bar company. He got the idea to start the firm while on a 175-mile bike ride in November 1990. While eating an energy bar he brought with him, Erickson decided he could make a better one. He spent hours in his mother's kitchen, and in 1992, shipped the first Clif Bars to distributors. His business partner continued to run the bakery for 15 months while Erickson focused on creating the energy bars.

As a startup entrepreneur, Erickson had the luxury of focusing on only a few key tasks, such as product development, sales and marketing, packaging and distribution, while his competitors faced economic challenges. The product Erickson worked hard to create in his mother's kitchen has grown into a diversified firm offering the Clif Bar energy bars, sports drinks, wine, and more. The company took in \$176 million in net revenue in 2008.

Clif Bar is just one high-profile firm launched or conceived during a recession. More than half the Fortune 500 were born either in a recessionary period or in a bear market, according to research from the Ewing Marion Kauffman Foundation, a Kansas City, Mo.-based nonprofit that researches entrepreneurship. Notable startups in recessionary periods include Microsoft, Burger King, and Hyatt.

Like many startup entrepreneurs, Erickson launched Clif Bar by applying lessons from prior experiences, receiving help from family, and following his passion. Success was far from certain. That's true for business creators who launch firms in economic expansions too. Entrepreneurship offers challenges and opportunities in good times and bad, though those challenges and opportunities may differ with changing economic conditions. But, one thing remains constant: Entrepreneurship soldiers on no matter the economic circumstances.

New technology costs have fallen over time, opening up new avenues for entrepreneurs-to-be. That's true regardless of whether the economy is in an expansion or a downturn. However, only recessions offer entrepreneurs something

COURTESY OF BURGER KING CORP.; CLIF BAR & COMPANY; HYATT HOTELS & RESORTS

vital to the development of new firms: a larger than usual supply of available skilled labor.

Starting a business requires capital. Financing through bank loans, credit cards, or by venture investors may prove harder to get in a recession, says Stephen Kaplan, a professor of entrepreneurship at the University of Chicago Booth School of Business. This will have a bearing on the success rate of businesses. Looking at current and past recessions can help us ascertain some insight about how businesses are born and how they survive.

Necessity vs. Opportunity

The Index of Entrepreneurial Activity, produced by the Kauffman Foundation based on data from the Census Bureau and the Bureau of Labor Statistics, documents new business creation. Overall, the index shows the rate of business creation rose slightly in 2008 to 0.32 percent of the adult population, meaning 320 out of 100,000 adults started a business each month in 2008. That's up from 2007's rate of 0.30 percent. Since 1996, the rate of business creation has fluctuated between 0.27 percent and 0.32 percent.

In the Fifth District, Washington, D.C.'s entrepreneurship rate has been the most volatile. Its rate spiked sharply from 1999 to 2000 and again from 2006 to 2007, but a steep decline followed both surges. Yet Washington, D.C., had a higher entrepreneurship rate in 2008 than in 1996. As shown in the table on page 15, the District of Columbia and Maryland are the places in the Fifth District that had higher entrepreneurship rates from 2006 to 2008 than from 1996 to 1998.

Trends in the overall average business creation rate may mask divergent patterns in business creation for different types of businesses. For instance, rough economic times tend to see the creation of more one-person businesses, while in better times, multi-employee firms emerge, says Brian Headd, an economist with the U.S. Small Business Administration. One-person firms represent 3 of every 4 businesses in the country, but their economic activity is relatively small. In 2002, of the 17.5 million one-person firms, only 3.5 million (20 percent) had annual receipts of \$50,000 or more.

Not all one-person firms stay in that category, however. Between a quarter and a third of firms that eventually employ workers started as one-person businesses, says Dane Stangler, an analyst at the Kauffman Foundation.

The survival rates for firms started in recessions are quite similar to those founded in economic expansions. An average of 48 percent to 49 percent of all new firms between 1977 and 2001 survived to age five. The biggest drop-off occurs in years one and two. This makes sense, Stangler writes, "when we consider that there is remarkable consistency from year to year in the number of new firms and establishments that Americans start."

Stangler notes that determining the effects of a recession on any single company is difficult. "There is so much churn and turnover, combination and recombination occurring at any given time in the American economy, that it's often

Recession Reduces the Supply of Credit



SOURCE: Federal Reserve Board of Governors

difficult to trace the effects of recessions or bear markets on any one company. Within one company, moreover, there will be multiple changes of business as management moves from opportunity to opportunity."

The Kauffman index also groups businesses into three categories of future income potential (based on past performance of firms in various industries): low, moderate, and high. From 2007 to 2008, the two lowest income potential categories drove the increase in business starts. During recessions generally, the creation rates for these businesses tend to be higher.

There are different motivations for entrepreneurial activity and some of that is dependent on the situation in which a businessman may find himself. What analysts call "necessity entrepreneurship" is the type that arises when a displaced worker launches a firm because it is his only option. That is distinct from "opportunity entrepreneurship," which can occur when an entrepreneur sees a niche to fill regardless of his employment status.

Both types of entrepreneurship can appear in recessions, says Ted Zoller, a professor of entrepreneurship at the University of North Carolina-Chapel Hill's Kenan-Flagler Business School. He says that you'd see necessity-based motivations among people just trying to replace their wages. Then you'd see opportunity motivations among individuals who are displaced by large companies that have access to markets being ignored because of the economic circumstance of the larger enterprises.

Small businesses create most of the nation's new jobs, employ about half of the nation's private-sector work force, and provide half of the nation's nonfarm, private real gross domestic product as well as a significant share of innovations. That's all according to the U.S. Small Business Administration in its 2009 report, *The Small Business Economy*.

Stangler suggests that of the firms started in 2008 and 2009, it's likely a tiny number may grow into the largest companies in 2020 or 2030, and a few hundred may eventually receive accolades as fast-growing firms. "When two or three dozen young firms hire four, six, or eight people at a

time for several years, it mostly goes unnoticed. Only when they reach sufficient collective size do they begin to appear in the public consciousness, even though they have been regenerating the economy for several years,” he writes.

The big question still remains: How do you fund a new business? The answer to that question will be influenced by how much capital entrepreneurs can access. In a recession, this entrepreneurial fuel may be hard to find.

A Great Future in Plastic?

Entrepreneurs have several different places to turn for money to launch their firms. They can utilize credit cards, take out other loans, get help from friends or family, or turn to venture-capital investors. Venture investing is a high risk game with a high rate of failure but large returns. During a recession, venture capitalists are more likely to invest in new companies only after they have shown some promise and are more likely to band together to make investments to share risk, Zoller says.

Philippe Sommer, director of the entrepreneurship program at the University of Virginia Darden School of Business, formerly ran a venture fund and described the thought process he used when picking projects. “We used to talk about three kinds of companies: A companies, B companies, and C companies,” he says. “A companies” were firms with the right people, the right approach to the market, and a strategy that made sense to a funding source. It’s no surprise that those companies tended to get funded in both good and bad times. But the “B” and “C” firms, some of which might receive funding when the economy was doing

well, were less likely to receive money during recessions.

No matter how one gets the funding, creating a business and reaping the benefits of entrepreneurship is costly. Starting a business, on average, costs about \$31,000, though those costs can vary widely by industry.

Entrepreneurs often use credit cards to cover those costs. From 2007 to 2008, more than 90 percent of small business loans were for less than \$100,000, and many of them were on credit cards, according to Kauffman research. More than half the firms surveyed by the foundation relied on credit cards to launch, and nearly a third carried a balance. However, every \$1,000 in debt increased the likelihood of firm failure by 2.2 percent.

As the recent financial crisis worsened, you would expect the supply of credit to tighten and also for people to be more reluctant to take on debt. Federal Reserve data indicates that the amount of revolving debt — which is overwhelmingly in the form of credit cards — plummeted in 2009. The decline of more than 7 percent between January and September is the largest over the last 30 years.

Existing credit card holders are finding their credit limits have been cut too. According to a FICO study, 33 million people, or 20 percent of the country’s card holders, had their limits reduced between October 2008 and April 2009. Of these, only 27 percent had their limits reduced because of negative items in credit reports.

Credit card loans may be harder to get because of bank fears over increased default risk during a severe recession. The October 2009 Federal Reserve Senior Loan Officer survey also notes that demand for loans continued to

The Demographics of Entrepreneurship

One of the most iconic faces of entrepreneurship in American history is one that appears on signs all across the nation. “Colonel” Harland Sanders started franchising his Kentucky Fried Chicken restaurant at age 65 with a family recipe for fried chicken and a \$100 Social Security check. That was in 1955. Less than a decade later, Sanders had 600 franchises in the United States and Canada.

Today, one of the prominent faces of entrepreneurship is Mark Zuckerberg, the 25-year-old billionaire and co-founder of Facebook, a social media Web site that is one of the 10 most visited sites in the world. Zuckerberg took Facebook live from his Harvard dorm room in 2004, dropped out of school and relocated to Palo Alto, Calif., where he now runs the company.

Popular perceptions may suggest people like Zuckerberg and his Facebook co-founders represent the future of entrepreneurship. But they’re actually outliers, says Duke University professor Vivek Wadhwa. He co-authored a paper on technology entrepreneurship for the Ewing Marion Kauffman Foundation, and found that the average and median age of founders of technology firms was 39. “Experience is the most important ingredient of success,”

Wadhwa says. “The stereotypes are inaccurate and a legacy of the dot-com days.”

The age group that had the highest rate of entrepreneurship across all industries from 1996 through 2007 was 55 to 64. The age group of 20 to 34 had the lowest rate during this period, which included the dot-com boom.

Entrepreneurship in the age group of 55 to 64 is hardly a new phenomenon. People in that age range are far more “experienced, balanced, and wiser,” Wadhwa says. They also have less of something else — fear. “The strongest factor that prevents people from becoming entrepreneurs is the risk,” Wadhwa adds. “Once you’re in this age group, the risk and the fear is much less.”

Other factors can explain the prevalence of entrepreneurship among older adults. For one, people 55 and older may have more wealth they can use to launch a business, notes Dane Stangler, a Kauffman Foundation analyst. Also, some older adults may not possess the skills most in demand in a rapidly changing economy so they find themselves turning to self-employment as a way to making a living. That fact “lurks in the data” but is hard to tease out, Stangler says.

Stangler says these older and bolder adults could fuel

weaken across all major categories except for prime residential mortgages. Just as banks may have more fear about credit card holders defaulting, it's possible the specter of bankruptcy may cause consumers to hesitate taking on additional debt.

Access to credit is “the No. 1 issue” for entrepreneurs, Stangler says. Lack of credit may dampen new firm creation in a severe recession. Zoller says tighter credit will make it harder for the new firms that get started to survive. That's because new firms have to establish a durable cash flow and need working capital to cover operations while economic growth is slow. Without that, “I think you're going to see more failures during this recession than you've seen in previous recessions,” Zoller says.

Financing troubles may affect employment growth at small firms that do survive. David Altig, Federal Reserve Bank of Atlanta senior vice president and research director, notes that businesses with fewer than 50 employees account for about a third of net employment gains in expansions. They've also accounted for about 45 percent of job losses since the current recession started. “Given that these are the types of businesses most likely to be dependent on bank

lending — and given that bank lending does not appear poised for a rapid return to being robust, the prognosis for an employment recovery in these businesses is a question mark,” he writes.

Despite the difficulties, recessions can reinforce the can-do attitude of many — and that can spur entrepreneurship generally. “People are being called upon to take responsibility for their lives in different ways than they were 20 or 30 years ago,” says Jerome Engel, chair of the new venture program of the Haas School of Business at the University of California at Berkeley. “The current economic downturn makes increasingly apparent to people the need for autonomous individual action, on a local and small scale, to secure their financial futures.”

Those small-scale actions can lead to broader improvement in the economy over time. As Stangler writes, “despite the pain of the current recession, there is reason for hope — good things do grow out of recessions.” While the future of any specific new firm is hard to predict, the overall net value to the economy is likely to be positive in the long run. “Every generation of startups is, often invisibly, both a renewal and restructuring of the economy,” he notes. **RF**

READINGS

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an entrepreneurship boom. The country is now experiencing rapid growth in the numbers of people in the 45 to 64 age group, and life expectancy keeps growing. By 2050, American life expectancy is projected to be 83 years, compared to 78 now. If the rate of entrepreneurship in this group stays constant, this could all translate to a multitude of new companies in the future.

Rising entrepreneurship among older adults isn't confined to one type of business either. “The pattern generally holds across industries,” Stangler says. “There's no industry that stands out for being where the young people are starting companies, and another where the middle age and older demographic groups are starting companies.”

While more senior entrepreneurs may be forming companies, how likely is it those companies will produce major

Average Monthly New Business Starts

Per 100,000 Adults

State	1996-1998	2006-2008
D.C.	280	350
MD	250	270
NC	280	250
SC	300	230
VA	260	230
WV	190	150
U.S.	290	300

SOURCE: Kauffman Foundation

innovations like Facebook? Might an older entrepreneur be more likely to start a “lifestyle” firm, while a younger person more apt to start a groundbreaking one? “Such a concern makes sense, but further research needs to be done,” Stangler writes.

Kauffman Foundation research also demonstrates that immigrants tend to be more entrepreneurial than native-born Americans. One in four engineering and technology companies launched between 1995 and 2005 had an immigrant founder.

Immigrants are also more likely to start businesses of all types. They had higher entrepreneurship rates across all industries every year from 1996 through 2008. In that last year alone, the gap between the overall entrepreneurship rates of the two groups was the widest in the survey period: The rate was almost twice as high for immigrants as it was for the native-born population. — DAVID VAN DEN BERG