Interplay of various markets

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Business entails interplay of various markets –

- **Product / Service** – the market for what the business offers to its client / customer
- **Employment** – the market for the non-owner members of the team who make the offering possible
- **Capital** – the financial resources in various forms such as debt, venture capital, private equity, public equity etc. that support the expenditure inherent to the business until it is able to pay for itself
- **Enterprise** – the people who promote the business
- **Other input factors** – various other factors such as land, power etc. which are inputs to the business

The balance across these markets determines the performance of business, both at the company level and at the country level.

Liberalisation and competition have ensured that in most *product / service markets* in India, the balance has shifted decisively towards clients / customers.

The professional choice that people make is between *employment* and *enterprise*. Employee Stock Options, internal venture capital funding etc. help organizations retain employees by introducing the upside of enterprise into the employment paradigm.

Sources of *capital* earn returns from their underlying markets, but such returns are a function of the performance of business in its relevant markets. Thus, if interest rates go too high, then businesses become unviable. For new businesses that are to be funded by debt, the hurdle rate shoots up.

Equity capital is meant to be risk capital. Venture capital, private equity and public equity reflect different shades of risk appetite that financiers are comfortable with. When the returns in the financial market are attractive and financiers are more open to risk (during the tech boom for instance), *money chases projects*. This reduces the bar for new projects, and incentivises people to move from employment to enterprise, even with weak business models. Result: Failure rates of businesses rises and financiers lose money.

When the pendulum shifts the other way, and financiers become risk averse, projects chase money. Only the "good" projects get funded, pushing up success rates of business. Enterprise suddenly looks less appealing.

Markets are expected to behave irrationally. *So pendulum shifts are more common than the subtle shifts in direction of aircrafts and ships*. During a shift from risk preference to risk avoidance, it becomes more difficult for enterprises to fund operations. Failed businesses become available cheaper than new businesses. This introduces a new element of difficulty for new business ventures to get funded.

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Failed businesses, starved of funds over an extended period, lose their economic rationale and become less attractive for an acquirer. When this happens, new business finds it easier to get funding. The time it takes for the funding preference balance to shift from failed businesses to new businesses is determined by the nature of the business. The shorter the *time to decay* for a fund constrained business, quicker the shift in balance towards a related new business.

The ability of financial markets to quickly open and close funding lines introduces an imperative of short-term results (read quarterly results), even at the cost of long-term direction. The markets for instance are happy with amazon.com attaining breakeven, even if that has been attained at the cost of amazon's own preferred long term strategic positioning.

Of the other input factors, land deserves special mention. When land is made available cheap (for instance in export processing zones), the hurdle rate for success of businesses goes down, making it easier to justify projects. This is one of the plays in the China story, where land is available for enterprise virtually free.

What is the learning for the country and its entrepreneurs?

The ideal role of the government should be to continuously monitor the various markets to eliminate imbalances and thus ensure a *virtuous circle of prosperity*. Buoyant product / service markets would lead to adequate returns to employees, promoters, financiers and other input factors which in turn will contribute to business confidence and demand for products and services, perpetuating a buoyancy in the overall economy. An imbalance in any of these markets can quickly degenerate into a *vicious circle of poverty*.

Entrepreneurs need to be realistic about the scale and nature of business they venture into. They need to have a position in the various markets that would take the business in the preferred direction to the cherished destination. For instance, they need to have own funds or committed outside funding for the entire *time to breakeven* plus a buffer. In an environment of extreme business risk, it would be preferable if the servicing of such funding is subject to financial viability of the business. Therefore, equity funding becomes preferable, unless of course the business is being implemented under a balance sheet that has independent sources for servicing debt.

Similarly, the business should be able to sustain and support the core skill sets for the business, either as employment or enterprise. The other input factors should preferably not become a drag on the business. It is in this context that some of the recent retailing business models, where property rents are linked to performance of the business, make sense.

A market-based view to business would ensure progress of countries and companies along a route that is less susceptible to market inefficiencies and irrationalities.