Entrepreneurs Aren't Risk Takers – They're Arbitrageurs!

by Mohnish Pabrai

Last year, former Harvard professor, Amar Bhide wrote a book on the subject entitled *The Origin and Evolution of New Businesses*. Bhide spent several years interviewing hundreds of Inc. 500 CEOs to get to the core of this elusive beast called *entrepreneurship.* His conclusions are counter-intuitive and studying them should be required reading for every would-be entrepreneur and investor looking to invest in anything ranging from startups to the public equity markets.

Bhide's research showed that virtually all startups fall into two categories – *marginal startups* (hair salons, lawn care etc.) and *promising startups* (Microsoft, HP etc.). Marginal startups have low uncertainty, low investment requirements and low likely profit. Promising startups have high uncertainty, low investment requirements and low likely profit. However, both types of startups have two things in common – both are **low risk** and arbitrage oriented. This is contrary to the myth that entrepreneurs are risk takers. When Gates dropped out of Harvard and started Microsoft, his opportunity cost was very low. He was not worth much in the job market and, had Microsoft failed, he could simply go back to Harvard and finish his degree. He faced uncertainty and ambiguity, but not risk.

Consider the example of a skilled hairdresser who notices that there are no salons within a 24-mile radius of her urban surroundings. She scrounges up her savings and opens a little salon with very basic infrastructure. Her risk of failure is quite low since folks need

to get their hair cut and they are currently driving atleast 24 miles. Because of the compelling proposition, she soon gets a steady and growing clientele. She has virtually no risk because if the venture fails, she simply goes back to working at another salon. The upside is better than working at another salon, but it's unlikely that she'll end up on the Forbes 400 as a result. Essentially, she's engaged in arbitrage. The arbitrage "spread" is the 24 miles between her and the next salon. As she gets busy, another hairdresser notices and leaves her job and opens a salon 12 miles away. Then another one opens 3 miles away and so on. Eventually, the market becomes efficient and net changes in salon chairs match population changes.

When Gates and Allen launched Microsoft in 1975, their only product was an 8080 BASIC compiler that ran just on an Altair computer. At the time, they were the only ones serving this small niche. Similarly, HP started with an audio oscillator for which there was very limited demand. Both companies essentially were acting as arbitrageurs in their respective markets. They were collecting the "spread" till other entrants show up. Both had no grand plan to get them to where they are today. They simply were trying to be resourceful and survive. Arbitrage players have to jump from one niche opportunity to another. Even formidable Fortune 100 companies like Microsoft and HP started out as arbitrage players – jumping from one business to the next to stay alive.

Arbitrage, by definition, is low risk and typically a return slightly higher than the risk. If Gold is being quoted in London at $275/ounce and $280/ounce in Frankfurt, arbitrage players quickly jump in buying in London and selling in Frankfurt till the spread

eventually equals transaction costs.

But an astute investor – whether looking to invest in Microsoft in 1975 or our salon when it still enjoys the 24 mile advantage is not usually looking for an arbitrage spread. Buffett succinctly says, *"The key to investing is … determining the competitive advantage of any given company and the durability of that advantage."* Our salon has a wonderful competitive advantage when it starts, but that advantage is not durable. Hence it would make a poor investment. Similarly the barriers to entry for others to create a BASIC compiler for the Altair are essentially nonexistent.

The good news for entrepreneurs and investors is that the arbitrage spread can occasionally last for years. Given enough time, some durable barriers to entry may be created such as brand, scale or a loyal customer base. Nonetheless, Bhide research clearly shows that the business model of the overwhelming number of startups is straight arbitrage and any sustainable competitive advantage is non existent at the time of startup.

Both Microsoft and HP would have failed Buffett's durable competitive advantage test in their early days. To scale, both jumped from one niche to the next without much planning or analysis. Any one wrong jump would have done them in.

Most companies, however, are unable to keep successfully jumping from one arbitrage opportunity to the next and thus wither away. The ones that choose not to jump (like our salon) remain small. U. S. Government data indicates that 60% of the million annual

startups fail in the first six years. More importantly, the overwhelming number of the ones that survive remain small.

I'd like to suggest that durable competitive advantage is usually the result of unpredictable and rare random events - like IBM's call to Microsoft to sell them a PC operating system when Microsoft had never built an operating system before and did not have one to sell. These events have no pattern and cannot be forecasted when a startup is being formed. They happen to a very small minority of startups. Once a startup has acquired a durable competitive advantage and one gets an opportunity to invest in one well below intrinsic value, backup the truck.

Since entrepreneurs are arbitrageurs, they are constantly looking at companies with durable advantages and try to find a way to carve away a piece of that advantage for themselves. Durable competitive advantage is an anomaly and quite rare. When The Coca Cola Company got started, they had a unique product which delivered high value to its customers and the drink was wildly popular. Making a drink like Coca Cola was not rocket science and soon enough numerous other "colas" emerged. These new arbitrage players offered lower prices or introduced it in locales when Coke had not yet reached. In time there were hundreds of "cola companies" with names similar to Coca Cola. Most folks would ask for Coca Cola and vendors would freely serve any other brand they were selling. Coke was in a fix and finally, their brilliant lawyers used this behavior to sue all the other Cola companies and their vendors – driving them all out of business through high legal costs etc. One company, Pepsi, in Canada, got away and today represents Coca Cola's primary competitor.

Thus the Coca Colas and the Microsofts of the world are under a constant barrage of thousands of entrepreneurs nipping at their heels, trying to make inroads. In another fascinating book, *The Living Company,* Arie de Geus found that the average life of a Fortune 500 company was less than 50 years from birth to death. The Fortune 500 represents the businesses that were able to take advantage of some aberration and build durable competitive advantage. Arie found that even then "durable" companies were mortal and eventually one of those nipping entrepreneurs did them in (Walmart/K-Mart, Canon/Xerox etc.).

To conclude I like to say that startups drive our economy and our vital to our future. However, investing in most of them is akin to gambling. The odds are not in the favor of the investor. Even investing in the few well-established companies with durable advantages is fraught with peril. De Geus clearly demonstrates that there is no such thing as a permanently sustainable enterprise. As hard as it may be to imagine, one day, there will be no GE or Microsoft or Taco Bell. Hence the need to invest in them at a substantial discounts to intrinsic value with a Ben Graham "margin of safety" such that one is able to realize a good return within the first few years of the investment being made.

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