

Starting up

Achieving success with professional business planning

Contents

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Design and realization: Mifflin-Schmid, Zurich

Printed in Switzerland

ISBN 90-9011748-2

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THE NEW VENTURE BUSINESS PLAN COMPETITION

An incentive for setting up companies

New Venture is a business plan competition that gives students, researchers and others in the Netherlands the opportunity to set up a company on the basis of an innovative business idea. New Venture is an initiative of McKinsey & Company and is organized by de Baak, Management Centrum VNO-NCW.

New Venture is looking for ambitious new business ventures based on promising and viable ideas. Projects of this nature require great commitment and farsightedness on the part of their initiators, experience in starting up companies, and — of crucial importance — access to investors who are prepared to finance such projects. New Venture provides participants with the ideal environment for learning, refining, and actually setting up a promising business venture.

Three rounds

The Dutch New Venture business plan competition includes the following rounds:

Round 1: Concept and presentation of a business idea. This round focuses on how to articulate your business idea. This is the first step towards the actual writing of a business plan: you have to get a clear picture of *what* exactly you want to deliver to *which* customers.

Participants of this round have to describe what problem their idea solves, what is new about their product, why customers would want to use it, who the target group is and who is going to pay for the product.

The jury, which mainly consists of professional venture capitalists, will provide feedback to the participants who entered an innovative idea at the end of the round.

Round 2: Assessing the feasibility and potential of the start-up company. This round examines the feasibility of your idea and what need the product or service addresses. With the help of your team coach (experienced

manager), and market researchers, lawyers and accountants, you will not only estimate your idea's chances of success, but also discover unexpected opportunities.

In this round you have to answer the following questions: Are you able and allowed to produce your product on the necessary scale? In what way is your product better than its competition? Who are your competitors, and how can they be prevented from copying your idea? What is the current and long term market potential? What price are your customers willing to pay for your product, and will that be enough to make a profit?

The analyses of this round will eventually end up in your business plan — if your idea proves to have the required potential. Should your idea fail to “pass” this feasibility test, you have at least have been prevented from writing an entire business plan for nothing.

Entries to this round will again be judged by the jury. The participants will be provided with feedback.

Round 3: Preparation and presentation of the business plan. A strong business plan meets the requirements of investors in terms of both form and content. In this round, participants again have access to their coaches, and to a wide range of specialists that will help make the business plan a “winner”.

Your business plan must answer all questions regarding your future enterprise an investor might have, so it must report your product idea, the profiles and competencies of the management team, the marketing possibilities of your product, the way your company will operate, the detailed time planning of the realization of your company, the risks involved and the financial planning.

At the end of this round, there will be a presentation to the jury of the most promising plans. There are three prizes of Dfl. 50.000 each for the best business plans.

Additional information

You can get additional information about the requirements for each round of the competition at our web site, www.newventure.nl, and from several **kick-off and networking events** at universities.

The New Venture Business Plan Competition offers ongoing support and a wide range of information. In preparing your business plan, you will have access to experienced coaches, at no cost.

How to use this book for the competition

This book was written to be used by anyone who wants to set up a high-growth company, and it does not fully reflect the rounds of the competition in its structure.

For round 1, participants can follow the instructions of part 2 of this book: **The business concept and its presentation**. The example at the end of part two extensively describes what is necessary for the competition; check the New Venture website or the “**deelnameset**” for more information about the requirements of entries for round 1.

As round 2 in fact amounts to drafting parts of your business plan, instructions are to be found in part 3 of this manual: **Preparing the business plan**. The following sections are important:

chapter 2, *Product idea*, sections *The irresistible business idea* and *Protecting your business idea* (pages 59 to 62)

chapter 4, *Marketing*, sections *Market and competition* and *Choosing the target market* (pages 76 to 85)

chapter 8, *Finance*, section *Basic accounting principles* (pages 138 to 149).

For an example entry for this round, check the website.

For round 3, participants should follow part 3 of this book: *Preparing the business plan*, entirely, and compose their entry accordingly.

Part 4 is intended for management teams of Start-up companies – or consultants advising them – that have prepared a business plan and are now seeking to cover their capital requirements with funds from an outside investor. This part describes how the value of a business can be estimated and how venture capitalists look at the business as a potential investment.

Have fun!

We wish all participants in the Business Plan Competition an exciting and instructive time. The excellence of your work coupled with a bit of luck – you will need that too – could even be rewarded with one of the prizes: a great encouragement to pursue your promising idea.

PREFACE

The Netherlands has a long business tradition and has produced many great entrepreneurs. Whether Dutch-born or from other countries, they have enjoyed an environment that enabled them to put their ideas into practice. If we wish to remain an economic force to be reckoned with in the future, we must continue to spawn such entrepreneurs.

In the McKinsey report, “Boosting Dutch economic performance”, the lack of innovative start-ups was identified as one of the main obstacles for growth. To change this situation, the government can and does play an important role in stimulating new companies. The Ministry of Economic Affairs has launched the “Twinning Concept”, an initiative aimed at promoting the fast-growing Information and Communication Technology (ICT) sector. For its part, McKinsey has followed up on its report and taken the initiative to organize a business plan competition to help all potential entrepreneurs start up real businesses based on innovative ideas. Now de Baak Management Centrum VNO-NCW will continue the organization of the competition.

If you have picked up this manual because you have a promising business idea and you are thinking of starting up a company to realize it, then I encourage you to seize this opportunity and participate in our competition. We wish all those who join in New Venture an enjoyable and instructive experience and, above all, every success in the competition and, subsequently, in business.

Robert Reibestein

Managing Partner

McKinsey & Company, Inc. The Netherlands

ACKNOWLEDGEMENTS

This manual was originally created on the initiative of the Swiss office of McKinsey & Company. McKinsey's worldwide knowledge and experience of numerous start-up projects have contributed significantly to the content. Right from the start, however, the project has also enjoyed a great deal of support from outside sources. Many practitioners — experienced entrepreneurs and leading venture capitalists — have provided first-hand accounts of how successful enterprises come about, and the points that need particular consideration when starting up a company: Bernard Cuendet, Peter Friedli, Matthias Reinhart, Olivier Tavel, Hans van den Berg, Branco Weiss, Brian Wood and Hans Wyss.

Many of our colleagues from McKinsey Switzerland have contributed to this work in one way or another, in particular Benedikt Goldkamp, Jules Grüniger, Ralph Hauser, Ueli Looser, Felix Rübel, Bruno Schläpfer and Barbara Staehelin. Further, we thank the Dutch New Venture team for adapting the text to the Dutch competition and their many suggestions for improvement.

It is our hope that this manual will prove to be a reliable and helpful tool to all those who turn to it.

The authors

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Heinz Marchesi

Daniel Ilar

About this manual

Victory usually goes to those green enough to underestimate the monumental hurdles they are facing.

*Richard Feynman
Physicist*

About this manual

This manual is aimed at helping you through the first stage of starting up an innovative, high-growth company: writing a professional business plan. Read it if you have a new business idea with high-growth potential which you want to develop and realize. Your goal might for example be to set up a business that, in five years' time, has sales of around Dfl. 50 million, employs at least 100 people and operates nationally, if not internationally.

Basically, everything you need is available in the Netherlands. There is no lack of promising innovative ideas, our research and technology have an international reputation and financing is available in the form of venture capital or investment funds. In short, conditions here are almost ideal. The trick is to take advantage of these conditions to achieve a breakthrough.

Think big

Do not hesitate to do things on a large scale. Setting up a company is by far the largest step you'll take: it involves a tremendous effort. Comparatively, the extra effort required to generate Dfl. 50 million sales as opposed to, say, Dfl. 5 million, is small. Thinking big can even make the task easier, as many potential partners are more interested in large-scale proposals than less ambitious ones.

The importance of a business plan

Professional investors will only back projects that have a well-prepared business plan. They consider business plans very important for reasons that are relevant to anyone setting up a business.

The business plan

- ❖ Forces the people setting up the company to think their business idea through systematically, thus making sure that it will have sufficient impact
- ❖ Reveals gaps in knowledge, and helps to fill them in an efficient and structured manner
- ❖ Ensures that decisions are taken, so that a focused approach will be adopted
- ❖ Serves as a central communication tool for the various partners
- ❖ Lists the resources that will be needed, and thus reveals which resources will have to be acquired
- ❖ Is a dry run for the real thing. No damage is done if the likeliness of a crash landing is revealed in the business planning phase. Later on, however, the effects on the business, the investors and the employees of the company might well be disastrous.

A sound business plan, therefore, is the basis on which a business idea can be realized, and serves to obtain the capital required for setting up and successfully developing a business.

FOR WHOM THIS MANUAL IS INTENDED

This manual is aimed at anyone who wants to set up a business – particularly a high-growth business. It takes account of the fact that people who start up successful companies are not necessarily management or marketing experts.

To those with no management training this manual offers:

- ◆ A step-by-step introduction to the concepts needed to prepare a business plan and arrange the financing of a business idea.
- ◆ The basic knowledge needed to participate effectively in discussions and negotiations, and ask the right questions.
- ◆ The necessary business language: all the jargon and technical expressions you need to know are explained and used in the text. There is also an extensive glossary in the appendix of the book.
- ◆ References for further reading.

For those who have had management training, the manual offers a systematic approach to writing a business plan.

MANUAL DESIGN

This manual has been conceived both as a practical working tool and as a reference guide. This is reflected in its design, which basically matches the stages in the preparation and writing of a professional business plan that could successfully attract venture capital.

[Part 1, Starting up a company — how companies grow](#), describes the consecutive stages that a typical start-up company will go through on its way to realization and success.

[Part 2, The business concept and its presentation](#), describes how business ideas arise, what to look out for when describing a business idea, and how to recognize whether a business idea is likely to attract financing. This part also includes an example of what a business idea might look like.

[Part 3, Preparing the business plan](#), is the core of the manual. It contains eight chapters: one for each of the sections a business plan should include. The stages in the preparation of each section are set out in detail. People without prior business experience will also find some basic business knowledge in this part.

[Business plan Cityscape](#). An example of a professional business plan in both form and content.

[The appendix](#) contains a detailed table of contents, a glossary of important terms, and references for future reading.

PART 1

Starting up a company – how companies grow

**Many are stubborn
about the path
they have chosen,
few about the
destination.**

*Friedrich Nietzsche
Philosopher*

Starting up a company – how companies grow

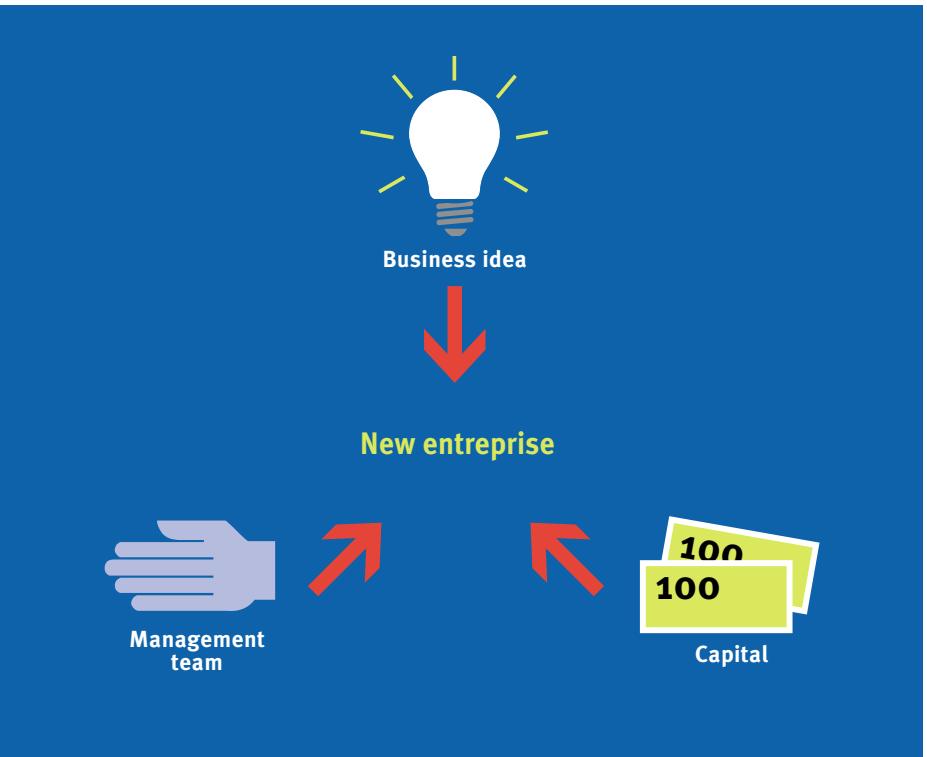
New high-growth companies are entrepreneurial ventures with the ambition of achieving substantial sales of, for example, Dfl. 50 million or employing, say, 100 staff within five years of their foundation. During this period, what began as a start-up should have become an established enterprise. This is a significant distinction compared to less ambitious company foundations. New high-growth companies are rarely in a position to finance themselves; they can only be realized with the assistance of powerful professional investors. Thus, for anyone setting up a high-growth company, finance is the existential issue. This means that, right from the start, the concept must be regarded from the perspective of future investors.

In this chapter, you will find:

- ◆ The essential factors in starting up a successful company
- ◆ How professional investors look at new companies
- ◆ The typical process for starting up a high-growth business.

STARTING UP A SUCCESSFUL COMPANY

Successful companies are set up by combining three elements.



- Without a business idea, there is no business. However, the idea is not the end of the creative process, it is its beginning. Many people are so in love with their idea that they fail to see that it is, at best, the point of departure for a lengthy development towards a mature business idea, and that it must withstand tough challenges before it even has any prospects of financing and market success.
- Money is essential. Luckily, adequate capital is available in The Netherlands, so that projects that are promising from the point of view of investors will undoubtedly find funding: the trick is to look at an idea from the investors' perspective.

3. The management team is the critical element in setting up a company. What distinguishes a good management team is discussed in full in Chapter 3, *The management team*. High-growth new companies are not one-man bands; they can usually be realized with a team of three to five entrepreneurs with complementary skills. Forming a team is well known to be a difficult process that requires a great deal of time, energy and sensitivity. So start on it right away, and continue working on it throughout the entire planning process.

TAKE THE INVESTORS' PERSPECTIVE

The entire start-up process must be geared toward the successful procurement of capital. Professional investors are the toughest test of a business idea's chances of success. So, focus all your communication on investors; learn to think the way they do. Even if you do not need an outside investor, you should look at your venture from this perspective. Investors will not be satisfied with a simple description of a business idea — however attractive it may be. Investors want to know exactly what they are putting their money into, and who the people behind the project are. For them, the team is at least as important as the idea. Investors also want to know, from the start, when their involvement will end, and how they will get their investment back. Making a profit is always the reason why investors want to get involved.

THREE STAGES IN THE START-UP PROCESS

Financing a business with venture capital

What is venture capital?

Venture capital is money for financing new businesses, made available by risk-capital partnerships or individuals. Typically, venture capital is invested in projects that offer a chance of high profit, but also involve high risk. Venture capitalists expect a profit from their investment corresponding with the risk involved. Accordingly, they follow a start-up project very closely to ensure that the potential is actually realized.

Besides financing, what do professional venture capitalists have to offer to a new entrepreneur?

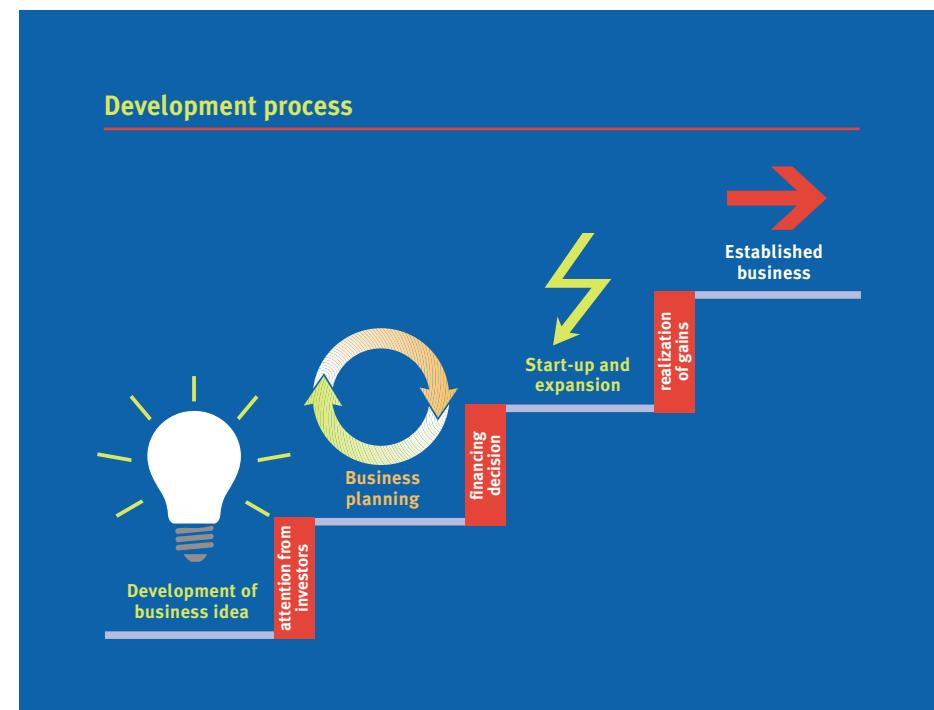
- ❖ Coaching and motivation for the founding team
- ❖ Specialist knowledge in building up new businesses
- ❖ Access to a network of experienced entrepreneurs, potential clients, business partners and managers who can help you make your business a success
- ❖ Advice on how to realize the success of the company (sale, listing of shares on stock exchange).

Venture capitalists will also move into the driver's seat if the management team fails to achieve its targets.

How to choose a venture capitalist?

Venture capitalists generally expect to take a significant share in a new business. But they also provide powerful support, that goes far beyond their financial involvement, and share decisive responsibility for the success of the business. There are differences between the various venture capitalists, and the management team should know its investors well. If you would prefer to have 20% of a Dfl. 100 million business than 80% of a Dfl. 5 million business, you should not only choose your investors according to who offers the most money at the best conditions.

The investor's perspective is reflected in the typical start-up and development process for high-growth businesses. For an investor, each stage ends with a milestone; for the entrepreneur with a hurdle that must be surmounted. It is important to have a clear understanding of the work involved at each stage, and the challenges that the hurdles represent. This will spare you not only unnecessary effort in setting up your company, but also disappointments.



In Stage 1 you put your business idea down on paper and analyze its marketability on the basis of a few key indicators. The hurdle that might be facing you as a founder at this stage is getting investors interested in the business idea and convincing them that it is basically worth financing.

In Stage 2 you will elaborate your business idea and turn it into a detailed business plan. Your hurdle at this stage might be to get access to the funds necessary to build up the business.

Use the planning process to decide if the business is really as good as you think.

Ask yourself if you really want to spend five years of your life doing this.

*Eugene Kleiner
Venture capitalist*

Stage 3 will require the most effort on your part. Business plan in hand, you will now have to build up a company that functions. Your goal is a successful business. One that is profitable and provides interesting employment for many people. When this stage is completed, it is time for the initial investors to withdraw: the company is no longer a start-up, but an established firm, which can be listed on the stock exchange or, alternatively, sold to another company.

If you want to be successful, this setting-up process will provide a structure for your task as the initiator of a business idea, and for the path leading to your own company. The investors' requirements will have a decisive effect on how, and with what approach, you handle the various stages of setting up your company.

Stage 1: Developing the idea

The starting point is one “bright idea” — the solution to a problem. This may be a new product or service, but it may also be an innovation within an existing business for example, a new production process, a new form of distribution, or some other improvement in the design, production or sale of a product or service. The idea must be tested to see whether there are customers for it, and how large the market might be. Basically, the idea itself has no intrinsic value. It only acquires economic value when it has been successfully realized in the market.

You need to start putting together a team and finding partners who will develop your product or service until it is ready for the market (or very nearly so – in the case of a product, this would probably be a working prototype). During this phase you will usually have to manage without venture capital. You will still be financing your enterprise with your own money, with support from friends, perhaps with state research subsidies, contributions from foundations, or other resources. Investors refer to this as “seed money”, as your idea is still a seed, not yet exposed to the harsh climate of competition.

Your goal in this phase must be to present your business idea and your market – the basis of your new company – so clearly and impressively that potential

investors would be interested in developing the idea further with you. You will find some basic practical tips on this in Part 2 of the handbook.

Stage 2: Preparing the business plan

In this phase, it is vitally important to keep an eye on the overall picture. Don't get lost in the details. The business plan will help you here: you must think through and weigh up the risks in your business idea. You must be ready for the unexpected, and learn to think in "scenarios". You must prepare plans and initial budgets for the most important functions of the business – for development, production, marketing, distribution and finance. And you will, of course, need to make a lot of decisions: which customers or customer segments will you address? What price will you ask for your product or service? What is the best location for your business? Will you do your own production or cooperate with third parties? And so on.

During the planning phase, you will be in contact with many people outside your founding team. Potential investors will not be satisfied with just reading a business plan. They will usually want to participate in its preparation before they get involved in the future company. If they are to support, coach, and contribute their industry experience and relationship networks, they will want to get to know the people behind the idea: Do they tackle their tasks with confidence? Do they demonstrate management and communication skills? Are they open and honest? Do they have relevant experience? Last but not least, are they able and willing to put their ideas into practice?

Apart from the investors, you will also need to talk to a large number of specialists: lawyers, tax consultants, market researchers, advertising agencies. You must also get in touch with your potential customers, to start estimating the size of the market. You must find your suppliers, and perhaps sign the first contracts. And you will want to get to know your competitors.

Limiting the risk

Taking the business planning phase seriously, and doing the work conscientiously always pays off. Ultimately, it will be the market that decides on the value of your business idea, and its judgment will be ruthless. The purpose of the business plan is to subject the idea to a thorough examination prior to this ultimate test; it's the idea's trial run before it faces the realities of the business world. While preparing the business plan, you and your future investor will together put all aspects of the business through a dry run. The professional venture capitalists will be the most rigorous judges, because they will be the most realistic. During this phase, you will have to show that the business can function, that the operating assumptions in the plan are realistic, and that you and your team are in a position to make the business successful in the marketplace. Despite every precaution, a high-growth company remains an investment risk. Experience shows that out of every ten venture-capital-financed businesses, on average only one will be a huge success, three will yield adequate returns, three will stagnate, and three will suffer total loss. So, it is understandable that investors do everything possible to limit the risks to their investment – on the other hand, risk is also their business.

Financing expenditure with your own funds

During this intensive concept phase, you will naturally be running up costs. The team must earn a living, a basic operation must be kept going, and a prototype developed. However, in this phase too, you should be able to have a good idea of the costs involved. Funds will still have to come from the same source or sources as in the first phase, though investors may on occasion be prepared to make an advance.

For you as the founder of the company, this phase is successfully concluded when investors are ready to finance your venture. You will find more about this in Part 3 of the handbook.

Stage 3: Setting up the company, market entry and growth

The conceptual work is now largely complete, and it is time to put the business plan into practice. From being the designer of the business, you now become its constructor. Business success must now be sought and achieved in the market. Typical important tasks are:

- ◆ Setting up the company
- ◆ Building up the organization and management
- ◆ Building up production
- ◆ Publicity
- ◆ Market entry
- ◆ Reacting to threats: competition, technological developments
- ◆ Expanding production
- ◆ Entering new markets
- ◆ Developing new products

This phase will show whether your business idea was a good one – and will finally be profitable.

Goal achieved: realizing your success

Realization provides proof of the success of your enterprise. If all goes well, you will be able to sell the business with at least the profit envisaged in the business plan. For the investor, a profitable exit has been the goal from the start. This need not mean that you too, as entrepreneur, leave the business. Entrepreneurs often remain in the business, though in many cases with reduced financial involvement. This enables them to enjoy the financial fruit of their labors.

Taking the capital out can be done in various ways. Normally, the business is sold, for example to a competitor, a supplier or a customer, or it may be listed on the stock exchange, by means of an Initial Public Offering (IPO). Another possibility is that those investors who wish to get out are bought out by the others.

The reward for your efforts

What began as a risky venture has now become an established business. In the course of its short life you have created a large number of jobs and gained many customers with your innovative solution. And the effort has also been worthwhile financially.

If your efforts are not crowned with success, at least you have gained some valuable experience, which will leave you better placed for a subsequent venture.

The business idea concept and presentation

**Shoot for the moon.
Even if you miss it
you will land
among the stars.**

*Les Brown
Renowned public speaker*

You look at any giant corporation, and I mean the biggies, and they all started with a guy with an idea, doing it well.

*Irvine Robbins
Entrepreneur*

The business idea – concept and presentation

The starting point for every single successful enterprise is a convincing business idea. It is the first milestone in the process of starting up a high-growth company. In order to be successful you should consider your idea from the investor's perspective. This means showing, clearly and concisely, what customer benefit your idea will deliver in which markets, and how it will produce money. Lastly, of course, you must present your idea convincingly.

In this chapter you will find out:

- ◆ How business ideas are identified and developed
- ◆ What a convincing business idea must include
- ◆ How to present your business idea to investors.

The CityScape case study at the end of this chapter shows the scope and degree of detail required in a developed business idea, and an example of how an idea might be presented.

The best way to have a good idea is to have a lot of ideas.

*Linus Pauling
Chemist*

HOW TO IDENTIFY A BUSINESS IDEA ...

Research has shown that most original and successful business ideas are developed by people who already have several years of relevant experience. It takes profound understanding of the technology involved, of customer behavior, or simply of the sector concerned to develop a business idea to the necessary level of maturity. Gordon Moore and Robert Royce, for example, already had several years' experience at Fairchild Semiconductors before they founded Intel.

However, there are examples of revolutionary concepts that have been discovered by utter novices. Steve Jobs and Steve Wozniak broke off their university studies to found Apple. Fred Smith had the idea of FedEx, the global parcel service, while at business school.

... AND HOW TO DEVELOP IT

In economic terms, even a “divine spark of genius” is worth nothing, however brilliant it may be. Usually, a lot of time needs to be invested in the idea for it to develop into a mature business idea: time for further development work involving various parties.

First, the idea must pass a plausibility check. This means making a rough check of the opportunities in your market, reviewing the feasibility of the project, and checking how innovative it is. Very quickly, you will be confronted with a wide range of questions, and the first problems will arise. You must overcome these step by step, by improving and refining your product idea, and by re-checking its plausibility. Do you have good answers to the questions? Are you showing ways to resolve the problems? Have you improved your idea's chances in the marketplace? If not, keep working on it.

Discuss your idea with friends, professors, experts, potential customers: the more broadly and thoroughly you investigate for your idea, the more clearly you will be able to express its benefits and its market chances. Then

you will be properly prepared for discussions with professional investors.

How long does it take to develop a business idea? That depends. Considering the development stages we have looked at, less than a month is highly improbable and hardly realistic. The business idea for a product or process development, for example, is only ready to be financed when it is concrete enough to be brought to market in the foreseeable future, and at a reasonably predictable risk. This may take years. Investors refer to this period as the business idea's "seed phase"; it is usually financed with "soft money", i.e., with funds that make no hard and fast demands on the success of the business.

It may also take a long while if the idea is ahead of its time. The perfect product has been discovered, but it cannot yet be realized, because the complementary systems or technologies have not yet been developed. An example of this is the Internet. There were plenty of ideas for marketing goods and services, but commercial exploitation of the Internet was long hampered by the inadequate security of the available payment systems.

Three ways to present a business idea

A young engineer has an idea for a new product, and wants to present her "business idea" to a potential investor. She knows that she must come straight to the point if she is to get a hearing.

Example 1: the sales approach

"I have a great idea for a new, customer-friendly payment system with enormous potential. This is what you have always wanted, and it will make you a lot of money". The investor thinks "All hot air. I've heard hundreds of "great ideas" – boring".

Example 2: the technological approach

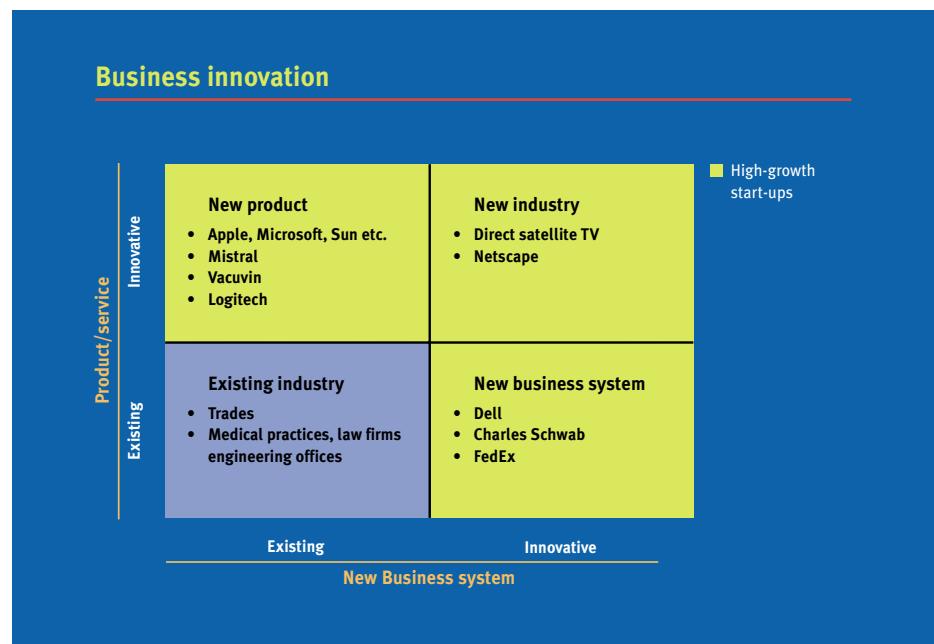
"I have an idea for a computerized machine control system. The key to it is a fully integrated SSP chip with 12 GByte RAM and direct governing of the control unit via asymmetric XXP technology; it's taken five years to develop". The investor thinks "Computer nerd; in love with the technology. She's her own market".

Example 3: the entrepreneurial approach

"I have an idea that offers a business with up to 100 staff cost savings of 3–5%. Initial cost/price analyses have convinced me that there is a potential margin of 40–60%. With the Small Businesses Association and ABC magazine, I have access to a focused publicity channel. Distribution would be via direct sales". The investor thinks "Ah; she knows what the customer benefit is, and has even quantified it. She's also thought about the market and the potential profit, and she knows how she intends to get the product to the customer. Now I should really like to know what sort of a product it is".

Innovative business ideas

Business ideas can be positioned according to two dimensions. The first dimension is the product/service the idea contains; the second is the way the product/service is developed, manufactured and marketed, referred to as “business system”. In both dimensions, it is possible to further develop what already exists, or to develop something entirely new. You will find more on business systems in chapter 5 of part 3, *Business system and organization*.



The concept of innovation is usually applied to new products or services that use conventional production methods and are distributed to customers using conventional distribution channels. Microsoft, for instance, developed the new DOS operating system, yet used IBM's existing sales organization to market it. Mistral used existing sports shops to distribute its surfboards. Bernd Schneider's Vacuin can be bought in any shop for household goods.

Innovations in the business system are less obvious, but every bit as important.

Dell's success was due to its significantly lower costs made possible by a new type of production and direct distribution system: computers were produced very quickly but only after they had been ordered. FedEx used central sorting and 24-hour operation to revolutionize letter delivery.

When developing new products, the emphasis must be on improving “customer benefit”. The point of innovations in the business system is above all to reduce costs. This benefit can then be passed on, at least in part, to the customer, as a price reduction.

Occasionally, it is possible to combine both dimensions of innovation – product and business system. This means inventing a new “industry”. Netscape made an essential contribution to the success of the World Wide Web when it made its new browser available at no cost via the Internet – Netscape makes its money by selling software to commercial customers and space for advertisers on its home page. Satellite TV offers an almost unlimited selection of programs, sidelining traditional program distributors, like cable or broadcasting companies, by operating its own satellites and by selling the necessary receivers through traditional consumer outlets.

If you can't say it
simply and clearly,
keep quiet,
and keep working
on it till you can.

Karl Popper
Philosopher

CONTENT OF A CONVINCING BUSINESS IDEA

The business idea has to appeal to an investor. It is neither an advertising leaflet for a supposedly amazing product, nor a technical description, but rather a decision-making document, which answers the following three questions:

What is the customer benefit; or, what problem does the idea solve? Market success comes from satisfied customers, not from amazing products. Customers buy a product because they want a need satisfied or a problem solved — be it by eating and drinking, reducing effort, increasing pleasure, enhancing their image, etc. So, the first characteristic of a successful business idea is that it clearly states what need it will satisfy, and in what form (product or service). The distinctiveness of the product is often referred to by marketing specialists as its “Unique Selling Proposition”.

What is the market? A business idea only has real economic value if people want the product or service. So, the second characteristic of a successful business idea is that it demonstrates the existence of a market for the product or service, and identifies the target customer group(s).

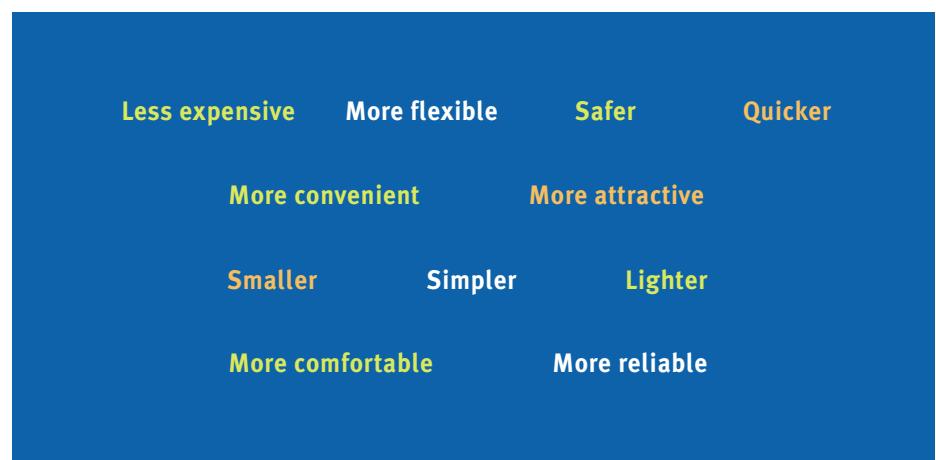
How will it make money? Most products make money directly, from sales to customers. In some cases, however, the “revenue mechanism” can be more complicated: for example, the product is given away for free to the consumer, and paid for by advertisers. So, the third characteristic of a successful business idea is that it makes clear how money will be made, and how much.

Customer benefit

Your business idea must be the solution to a problem that matters to potential customers in a market. Many entrepreneurs make the mistake of thinking about the technical details of the product when they refer to a “solution”. Investors do not think this way. They first consider the business idea from the perspective of the market and the customer. For them the key factor is customer benefit — everything else is of secondary importance.

Anyone who says: “Our new equipment can carry out 200 operations an hour”, or: “Our new machine has 25% fewer parts”, is only thinking about the product. On the other hand, anyone who says: “Our new equipment saves the customer 25% of his time and thus 20% of his costs”, or: “With our new solution, you can increase your production by 50%”, has adopted the point of view of the customer. In other words: the product or service is a means of providing customer benefit, never a benefit in itself.

The customer benefit of a product or service is determined by what is new or improved about it, compared to alternative solutions. It is thus an essential means of differentiation, and decisive in the market success of your business idea. You should also try, whenever possible, to express the customer benefit in figures.



In marketing theory, the customer benefit must often be expressed in terms of a Unique Selling Proposition, or USP. There are two aspects here. First, the business idea must be offered to the customers in a form (selling proposition) that makes sense to them. Many new companies get nowhere because their customers fail to understand the product's advantages, and do not buy it — and you cannot blame them for this. Second, the offer must be unique. The customer must choose your solution among those offered on the market. So you must also convince the customer that your product or service offers greater benefit or more value. Only then will the customer choose your product. It is difficult to entice people away from what they are used to and comfortable with. A potential customer who is interested in a new product will first look at what established manufacturers have to offer. You will probably find it easy enough to check the truth of this statement against your own consumer behavior.

When describing your business idea, you don't yet need to present a fully matured USP — but its principles should be made clear. You will fill it out later, when you work out the business plan.

Market

Thinking about the market and the competition requires some marketing knowledge. Readers with no business experience are therefore recommended to first study the chapter on marketing in part 3 in this manual.

What is the market for the product or service offered?

Investors are particularly interested in two questions when they think of the market:

- ◆ How large is it?
- ◆ What are the primary target groups or segments?

Detailed market analysis is not necessary at this stage. An educated guess of the market size and segments will be enough for the business idea. To be more certain, you could make an estimate based on easily verifiable basic data from the Department of Statistics, from trade associations, or from the trade or business press. It should be possible to define the size of the target market by using reasonable assumptions based on these data.

Obviously, it is not easy to define and specify target segments. For the business idea, an initial notion of who the target customers are will be enough. You should, however, show why your business idea offers particular benefits to precisely these customers (e.g., people with high incomes, those keen on technology) and why this group is particularly interesting to you economically. In the CityScape example, the business idea is interesting for small and medium-sized businesses that want to have a presence on the Internet, but regard their own direct involvement as too expensive.

Revenue mechanism

Greatly simplified, the classic profit calculation for a business works as follows: a business buys materials or services from suppliers, the payments for which represent costs for the business. The business then sells products or services to its customers, and this produces revenue. Later, when you prepare the business plan, you will have to set out the business system and the revenue mechanism of your business in more detail (see Part 3, Chapter 5). If possible, try to make a rough estimate of cost and revenue. A rule of thumb for high-growth businesses is that during the start-up phase they should achieve gross profit (revenue minus direct production costs divided by revenue) of 40 to 50 percent.

Not all businesses follow the classic pattern. Leasing and renting are other common revenue mechanisms. Three further examples: McDonald's earns its money from license fees charged to the franchise holders: the restaurant owners pay McDonald's for the use of the name and the model for running the restaurant. *ViaVia*, a classified ads newspaper,

is financed by the price paid by the people buying the paper; the advertisements appear for free. In the CityScape example, the service (information) costs the consumer nothing, and the business makes its money from the fees paid by companies that rent a home page. If your business idea is also based on an innovative form of revenue mechanism, you will need to explain it at the business idea stage.

Checklist

Does your business idea answer the following questions?

- Who is the customer?
- Why should the customer buy the product? What need does it meet?
- What exactly is innovative about the business idea?
- Why is the product better than comparable alternatives?
- What are the competitive advantages of the new company, and why can a competitor not simply copy them?
- How unique is the business idea? Can it be protected by patent?
- Can the product make money? What are the costs involved, and what price can be asked?

PRESENTING THE BUSINESS IDEA

Professional investors have clear basic requirements that business ideas must meet to merit their consideration. Your venture will only survive this stage if it meets these “killer criteria”. Naturally, although investors live with the risk of losing their money, they will always try to limit this risk as much as possible. A single reason can be enough for them to stop pursuing a business idea.

Characteristics of a promising business idea:

- ◆ Meets a customer need – a problem is solved
- ◆ Innovative
- ◆ Unique
- ◆ Clear focus
- ◆ Offers long-term profitability.

The way you present your business idea to an investor will be the acid test of your efforts so far. What really matters is to get the investor to take notice and show interest — because of the content, and because of your professional presentation. Good venture capitalists for example, receive up to 40 business ideas every week, and their time is limited.

Your first goal, therefore, is clarity. You should not expect investors to be familiar with your product's technology or the jargon of your trade. Investors are unlikely to take the time to find out what a confusing term or concept means. Conciseness of content and expression is your second goal. There will be plenty of time later for detailed descriptions and exhaustive financial calculations.

Formal presentation of the business idea

Title page

- ◆ Name of the product or service
- ◆ Name of initiator/entrepreneur
- ◆ Confidentiality notice
- ◆ Illustration, if appropriate.

Maximum of two pages of text, including:

- ◆ Description of product or service
- ◆ Customer benefit
- ◆ Innovative characteristics
- ◆ Description of customers
- ◆ Revenue mechanism.

Maximum 4 illustrations or charts, if necessary, to understand the idea

CityScape

Business Idea

April 7, 1997

CONFIDENTIAL

This CityScape Business Idea is confidential. Neither the plan nor any of the information contained in the plan may be reproduced or disclosed to any person without the written permission of CityScape.

CityScape Business Idea

The problem: local information is hard to find on the Internet

The Internet and Word Wide Web (WWW) have established themselves as the backbone of the world-wide "Information Superhighway" and of the electronic commerce market. Given the rapidly growing number of WWW users, many companies are looking for ways to exploit the advantages that this new distribution channel has to offer. However, for the end-users it is becoming more and more difficult to find the desired information quickly and reliably, as the number of available "Homepages" and the quantity of on-line information is exploding. Furthermore, there is no easily accessible WWW platform for small locally-oriented businesses that would enable these businesses to use this new channel effectively and with financial success.

The solution: a new way of organizing local information

CityScape solves this problem: it is both an interactive WWW directory service and a commercial platform for small to medium-sized businesses (exhibit 1):

- CityScape organizes everyday information such as current events, local happenings, local weather forecasts, restaurant guides, movie listings, listings of residential addresses and information about local businesses, and their offerings, in an easy-to-use and interactive way.
- CityScape serves as a conduit through which local merchants can both advertise and sell to local customers. This service extends from the posting of a contact address to complete interactive catalogues with integrated commercial transaction processing.

The innovation: integration of local information

The innovation of CityScape lies in its interactive and, to the end-user, appealing integration of every day information that usually needs to be gathered from different sources such as newspapers, telephone books and the radio.

Additionally, CityScape offers small to medium-sized businesses that are not technology sophisticated an opportunity to be commercially present on the WWW.

The market: roughly 5 million small-sized businesses as potential customers

Potential customers of CityScape are small and medium-sized companies that currently market their products and services via conventional channels such as the yellow pages, print media and radio. A rough estimate of the number of businesses that could become CityScape customers in the Netherlands and its neighboring countries (Germany, Belgium, etc.) is more than 5 million. Looking at the average advertising expenditure of such businesses we believe that they will find CityScape an attractive offer at prices between Dfl. 50 and Dfl. 500 per month. At this price level CityScape would be commercially viable and interesting for potential employees and investors alike.

CityScape's main competitors are traditional channels such as newspapers and the Yellow Pages. Compared to these channels CityScape has distinct advantages due to the interactivity and multimedia-capability of the WWW.

Revenue generation: monthly fees for service offerings

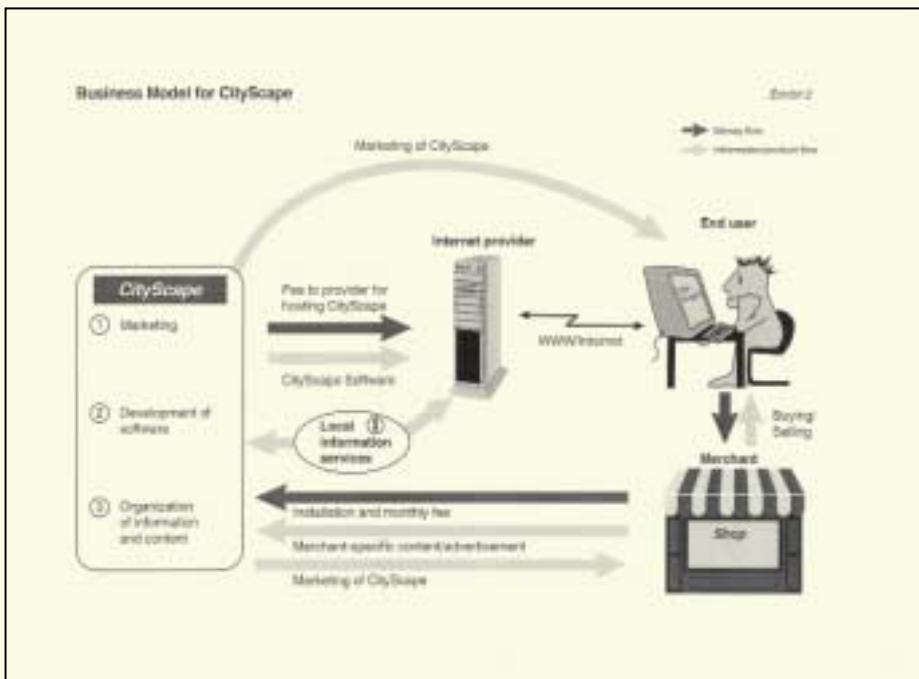
CityScape is free to all end-users. A high enough number of end-users provides the incentive for businesses and merchants to be present on CityScape in exchange for a fee. The fees depend on the required service level, e.g., basic, premium and catalogue service, and are divided into a one-time set-up charge and a monthly service fee.

CityScape specializes in marketing and sales to bring end-users and local small to medium-sized businesses together, as well as in the development and integration of Internet technologies (search engines, transaction processing, etc.). The provision of access to the Internet is subcontracted to local access providers (exhibit 2).

CityScape will be introduced first in cities and regions with high WWW/Internet usage; the goal is to establish CityScape as the de facto standard for local information management and for local merchants who wish to do business over the Internet.

PART 3

Developing the business plan



Writing a business plan forces you into disciplined thinking if you do an intellectually honest job. An idea may sound great in your own mind, but when you put down the details and numbers, it may fall apart.

Eugene Kleiner
Venture capitalist

Developing the business plan

You now have taken the first steps on the way to starting up a business. You have clearly formulated the customer benefit of your product or service, and your initial market research has given you confidence that there is a market for your idea, and that a successful launch and rapid growth are possible. You may already have convinced investors of your idea's possibilities and won them over as partners for its further development. However, there is still much to be done before you can expect a positive decision on financing. The business plan gives you a tool that will enable you to develop your business idea systematically until it is ready for presentation.

Structure of the business plan: The business plan should contain eight sections, which are extensively discussed in the remaining chapters of this part of the book. Order the parts of your plan as they are ordered here. The business plan for the CityScape case represents one possible practical example of a plan's development and presentation.

Content of the business plan: Your business plan should give clear and concise information on all important aspects of the proposed business. This includes practical matters concerning its start-up, operation and management, and analyses of costs, sales, profitability and growth prospects. This information will reveal whether your business idea stands up to closer examination, and where you may need to make modifications, or even think again. If you deal with professional investors, they will support your planning efforts and act as coaches and mentors. By doing this, they will take on an important role in starting up the company.

Writing a business plan requires more basic business knowledge than the previous phases. Readers without specific business education or experience will find the necessary basic knowledge in the following chapters. The information is presented in a concentrated form, which will help you consider the most relevant issues and enable you to act as a competent discussion partner. Readers with a business education or experience can use it as a guideline for key issues to consider when starting up a high-growth company.

Formal design of the business plan

A professional business plan is:

Effective: It contains everything investors need to know in order to finance the enterprise – nothing more and nothing less.

Structured: It has a clear and simple structure (for an example, see the structuring of the chapters in Part 3 of this manual and the sample business plan)

Comprehensible: It is written clearly, and to the point. It uses precise wording, no jargon, no waffle.

Brief: It does not exceed 30 pages, including appendices.

User-friendly: The type is at least 11 pt, with at least 1½ line spacing, and the margins are at least 2.5 cm.

Attractive: The figures and tables are simple and easy to grasp; avoid graphic “special effects”.

Conciseness is also a matter of style

Some tips from well-known authors

The guiding principle of style should be that a person can only think one thought seriously at any one time.

Schopenhauer

Choose the particular word, not the general one.

Classic rule of style

Never use a long word where a short one will do.

George Orwell

Before you use an adjective, come and see me on the third floor and ask me if you need to.

*Georges Clemenceau,
newspaper publisher, to a young journalist*

Main clauses. Main clauses. Main clauses.

Kurt Tucholsky's advice to speakers

The verb is the backbone of the sentence.

Ludwig Reiners

Read what you write aloud.

Wolf Schneider

He said, nice and clearly, what was to come first, second and third.

Wilhelm Busch

A good Executive Summary gives me a sense of why this is an interesting venture. I look for a very clear statement of the long-term mission, an overview of the people, the technology, and the fit to market.

Ann Winblad
Venture capitalist

1. Executive Summary

The executive summary gives a quick overview, and provides everything that a reader who is under time pressure must know about your business plan. Clarity and comprehensibility are particularly important here. The summary is, as it were, the pencil sketch of your venture; the business plan is the finished picture. Nevertheless, it must give the reader every significant element of the whole picture. The subsequent chapters of the business plan elaborate on the information in the summary, and provide more detailed technical information. However, they should contain no surprises in the form of entirely new messages or concepts.

Producing a clear and concise summary of a business plan in two pages is often more difficult and time-consuming than writing twenty pages of detailed description. Synthesis requires an additional thought process and therefore time. And think of the reader: make sure the structure is clear and understandable. Use uncomplicated language — this will make it easier to read quickly. Make sure the plan is clearly presented — this will encourage people to read it. The idea is to get investors to read on. Before they finally decide to finance the start-up of your company, investors will want to know more about it, and find out if your plan will stand the critical test of the market.

And there is an additional benefit. As the synopsis of your insights, the executive summary can serve as the basis for clear and concise communication — for a short verbal presentation, for example: all the key points covered in two minutes.

**There is nothing in
the world as power-
ful as an idea whose
time has come.**

Victor Hugo

2. Product idea

The whole purpose of any new company is to provide a solution for a problem that exists in the marketplace — to fulfill a need of its potential customers. So your business plan begins by setting out the customer need and the proposed solution. You have already roughly sketched out some of the key elements of your future enterprise — customer benefit, market and revenue mechanism — in the description of your business idea. Now, in the business plan you need to specify and detail these elements. What is it that will make your idea irresistible in the marketplace?

Considering your business idea from a more practical perspective generally involves an iterative process, in which new insights into one element of the plan can affect others. Remain open to criticism and, whenever possible, get advice from experts, investors, entrepreneurs, colleagues and potential customers.

In this chapter you will find out:

- ◆ How to make your business idea irresistible
- ◆ How to protect your business idea
- ◆ What to keep in mind when presenting your business in a plan.

We keep moving forward, opening new doors, and doing new things, because we're curious and curiosity keeps leading us down new paths.

Walt Disney

THE IRRESISTIBLE BUSINESS IDEA

How does your business idea become a “killer idea” — something that is irresistible in the marketplace? You have already sketched out what is innovative about your business idea, and described a rough Unique Selling Proposition (USP). You must now define the selling proposition in the form of a recognizable and convincing customer benefit, and be more specific about its uniqueness. For example, it may be possible to improve the customer benefit by improving the product or process development.

The CityScape case provides an example of the way the business plan takes the problem and solution set out in the business idea a step further in terms of depth and detail.

PROTECTING YOUR BUSINESS IDEA

Only very few ideas are genuine, unique sparks of genius. Truly powerful ideas are not easily copied. In most cases you will have to find a middle way, that provides sufficient protection while still enabling fruitful discussion.

Patenting

Early patenting is particularly advisable for new products or processes. Get an experienced patent lawyer involved: the future success of your business may depend on patent protection. All industries have financially powerful competitors ready to use their clout to avoid the granting of an inconvenient patent — and they can continue giving you a hard time after the patent has been granted! Be careful: patenting may fail in its aim of protecting an idea, by making it public. This is particularly important if devoting a little effort to improving the product or process can invalidate the patent. Thus, for example, the formula for Coca-Cola has never been patented because a patent could have been effectively circumvented by making minor changes to the recipe without affecting the product's taste.

Confidentiality agreement

Lawyers, accountants and bank staff are obliged by law to observe confidentiality with regard to their clients' affairs. Professional venture capitalists also have every interest in preserving the confidentiality of their clients' ideas: anyone who gets a reputation for poaching ideas is unlikely to be offered new ones. The same applies to consultants. Nevertheless, a confidentiality agreement may be useful in some cases, as long as you are clear about its limitations. Even if you have a confidentiality agreement, infringements are often difficult to prove in court. In any event, have the agreement drawn up by an experienced lawyer. A better approach is usually to do some research into the reputation of any possible discussion partners, before you discuss your business idea with them.

Rapid implementation

Probably the best protection against "intellectual theft" is putting the idea into practice quickly. Getting from idea to successful business takes an enormous effort. This effort – known as scaling the "entry barrier" – can discourage potential plagiarists. Ultimately, victory goes to the fastest runner, not the one with the best running shoes.

PRESENTING YOUR PRODUCT IDEA

In this chapter of the business plan you demonstrate in a clear and straightforward way how your business idea solves a particular problem. Your argumentation should be comprehensible to non-experts and should include the following aspects:

- ◆ Outline the problem and its solution.
- ◆ Describe what is innovative about your idea; explain to what extent your solution provides the customer with a unique benefit; and quantify this customer benefit.
- ◆ Describe the patent situation, and, if relevant, details of the patent.
- ◆ Communicate visually. A picture of the product, the prototype, the service "in action", or a flow diagram of the process will make it easier for the reader to get a clear idea of what you have in mind. It also documents the state of development the product has reached.
- ◆ Go easy on the technical details – they are of no interest to investors, and are unlikely to have a positive effect on the decision whether or not to invest.

Product idea checklist

Does your business plan answer the following questions?

- What problem(s) does your idea solve? What customer need does it meet?
- What kind of product or service do you want to sell? What exactly are you offering?
- What is innovative about your product or service?
- How near is the product or service to being unique? How will you protect its uniqueness?

I invest
in management,
not ideas.

Eugene Kleiner

3. Management team

Starting up a high-growth company is a very ambitious undertaking. Success must be achieved and often fought for, step by step. In addition to the right idea, an appropriate environment and support from a wide range of partners, it will also require the untiring drive of the management team. Ultimately, it is the way that the business plan is put into practice that will make the difference between success and failure — and that will be entirely in the hands of the team.

The management team is thus the crucial factor in a company that is starting up. That is why this chapter has such a prominent position in the business plan.

In this chapter you will find out:

- ◆ Why the management team is so important for the start-up and what its distinguishing features are
- ◆ How to form a “dream team”
- ◆ How to present your management team to an investor.

Teams outperform individuals, especially when performance requires multiple skills, judgments, and experiences.

Jon R. Katzenbach

THE NATURE AND IMPORTANCE OF THE MANAGEMENT TEAM

There are three reasons why the team is particularly important for the start-up:

- ◆ There is a lot to do – the necessary allocation of tasks is only possible with a team that brings together complementary skills.
- ◆ New sorts of problems continually arise — a well-functioning team, well-deployed, will find the best solutions.
- ◆ Above all, external investors are putting their money into the team – it is ultimately the people behind the idea who will make it successful.

The team also has the advantage that the whole burden is shared across the team – if one member drops out, there should be no risk that the whole enterprise will collapse.

The team:

Allocation of tasks based on complementary skills

Building up a business is a process that requires a wide variety of talents that are rarely all found in a single person. Because the idea for the company is usually new, there are no standard solutions for the problems that arise. A group of people with complementary skills will always solve problems better than any individual ever could.

Simply by working as a team, you can avoid typical mistakes that occur in many start-ups. For example:

- ◆ Going off course: changes in direction are necessary in building up any business. They are often resisted by the founder, out of fear that the business concept may be watered down. In a team, criticism will more often be based on purely practical motives.
- ◆ Poor quality communication: presentations can be rehearsed before a critical audience, thus avoiding embarrassing mistakes.
- ◆ Learning from mistakes: a sales pitch that goes wrong can be better analyzed within a team. Was it the message? The people? The presentation? Should we try again?

Interaction within the team is the most important advantage of teamwork. But there are also more mundane advantages of having a group. During the start-up, for instance, information gathering is an important task. Since there is no money for professional advice, team members rely on their colleagues and contacts for information. A team naturally has access to more sources than an individual would have. Also, simple matters like having someone there to pick up the phone are more easily arranged when you have a team. Being easy to reach is important to customers, who regard absence as a sign that you are not yet ready to handle orders in a professional manner.

The team:

Excellent performance if properly deployed

Building a team is not as straightforward as it may appear. What looks like a team may in fact be no more than a working group. What's the difference? A working group produces the sum of the individual performance of its members. A team, on the other hand, produces a result that is greater than the sum of each member's individual performance — but only if it is properly formed and finds the right way of working together.

Teams are capable of excellent performance, but in practice opportunities to set up and use teams properly are regularly missed. One reason for this is that many people are brought up to aspire to individual performance. Grades at school, for example, are given on an individual basis, and many people are uncomfortable with being evaluated as a team. Another reason is that many people have already had unsatisfactory experiences with teams. They may, for example, have worked on a team just for the sake of being part of the team, which is ultimately a waste of time. Disappointing "teamwork" also characterizes groups that are actually dominated by one individual.

Simply bringing together a number of people will not result in good teamwork. A team must be properly formed and find the right way of working together, if it wants to significantly improve its chances of success in starting up a company. Follow the basic rules in this chapter and try to build the characteristics of an effective management team into your company.

Characteristics of an effective management team

- ◆ Complementary skills and strengths
- ◆ Shared vision – everyone wants to succeed in a shared pursuit
- ◆ At least three people, seldom more than six
- ◆ Flexible approach to problems
- ◆ Sticks together – especially in difficult situations
- ◆ Doesn't give up in the face of adversity, but reforms and clears the hurdle at the second or third attempt.

The team:

In the eyes of the investor

Investors tend to be much more impressed by the people behind an idea than by the idea itself. The personality, professional and social competence, and motivation of the initiator and his or her team will often determine the investor's decision for or against the project. This is why positive signals from the team can be decisive, particularly in the initial phase. Someone who cannot quickly get a group of people enthusiastic about working on an idea may well run into problems later, when

What professional investors are looking for:

- ◆ Has the team worked together before?
- ◆ Do the members have relevant experience?
- ◆ Do the founders know their weaknesses, and are they ready to correct them?
- ◆ Are the founders clear about their future roles? Is the ownership of the company clear?
- ◆ Has the team agreed on a common goal, or are there unexpressed differences of opinion?
- ◆ Are the individual members fully committed to the undertaking?

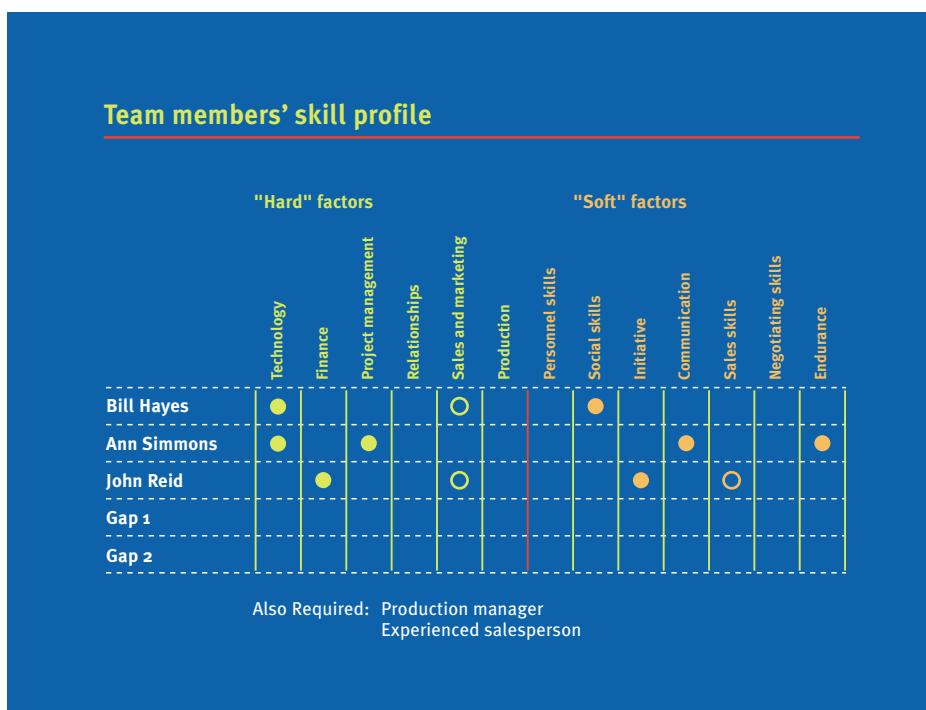
trying to get customers enthusiastic about it. Someone who lacks the social skills to help colleagues through the uncertainties of the start-up phase may later have problems managing a larger business.

FROM MANAGEMENT TEAM TO “DREAM TEAM”

To avoid blind spots in the development of the business, your team must bring together the most important skills required for the company. You can find out which skills you need by going, step by step through the organization and the business system (see Chapter 5). The exact requirements will obviously vary from business to business. Typical requirements, in addition to professional competence, are “soft” elements, such as communication skills, acceptance by the professional peer group, or by customers.

How does your current team match up to these requirements? How far away is your founding team still from the “dream team” that meets all these requirements? You can answer the questions by drawing a grid, putting the tasks to be carried out on one axis, and the available skills on the other (see figure). This will not only enable you to make best use of the abilities of those involved, but will also reveal any gaps. Be open and honest when making this assessment: recognizing that there are some gaps is nothing to be ashamed of, but a constructive step on the way to the dream team.

Filling the gaps is not easy. Your circle of friends may lack the necessary contacts (engineers tend to know other engineers, but not many economists). An experienced coach is particularly valuable here, and venture capitalists can also help.



Very few founders of new companies are in a position to employ the necessary team members, and thus retain full ownership of the company. Self-financing is particularly difficult with high-growth companies. To avoid disappointment, it is advisable to formulate a clear understanding of the ownership stakes in the future company at an early stage. The management team should agree on this before it begins talking to investors. A good approach for distributing the shares is to take account of the actual previous and future contribution of the members. Thus, for example, the “inventor” of the idea and the future chief executive would be entitled to larger shares.

PRESENTING THE MANAGEMENT TEAM

By setting up a founding team and by working hard to become a “dream team”, you have achieved a great deal. Now, you must convince your investors of the motivation and effectiveness of your team. Put yourself in their position: what would you regard as important? Describe the characteristics and skills of the team and its individual members, for example, in the following terms:

- ◆ **The team as a whole:** complementary skills of team members; evidence that the members can work together and also stick together under difficult circumstances; the members’ personal involvement in the team; distribution of ownership among the members; and role of each member in the team.
- ◆ **Individual members:** significant items of their CVs, such as education, professional training, practical experience, time spent abroad, management and communication experience; indications of special skills, particular hobbies or achievements in sports, music, etc. Be brief: not more than one-third of a page per member; complete CVs can be included in an appendix.

Management team checklist

Does your business plan answer the following questions?

- Who are the members of your management team, and what distinguishes them (education, work experience, success, business reputation)?
- What experiences and skills does the management team possess that would be useful for the realization of your business idea?
- What experience and skills does the team lack? How and with whom should the team be expanded?
- What motivates the individual members?

4. Marketing

The principal task of any company is to meet the needs of its customers. That is the basic idea of marketing. Marketing is not to be equated with “sales” or “publicity” — these simply represent the implementation of marketing ideas. Marketing is more comprehensive: whatever a business does — research and development, production and administration, sales and customer contact — there are always two key questions to be answered: What benefit does it offer the customer? What benefit does it bring the company vis-à-vis its competitors?

A company that bases its activities on a marketing approach will always strive to meet the needs of its customers — and to do so better than the competition.

The marketing plan is thus one of the key elements in your business plan. You must be able to convince investors that there is a market for your business idea — one that you can serve profitably. Investors would want to be sure that their expectations of the growth potential of the business can be met and so should you. For this purpose, it is not necessary to present a ready-to-run marketing plan as part of your business plan — nor would it be possible to do so in the 3-4 pages you have available. What is important, though, is a clear statement about the expected market, the pricing strategy, and distribution. For readers without business experience, a summary of the most important elements of a marketing plan has been included, to give them an idea of what matters most.

In this chapter you will find out:

- ◆ How to analyze your market and the competition
- ◆ How to choose your target market
- ◆ How to determine your marketing strategy.

If you don't know what the customer benefit is, the whole thing's a waste of time.

Branco Weiss
Entrepreneur

Basic elements of the marketing plan

Marketing is not an exact science and, particularly in the case of new business ideas, you must often rely on your common sense and instinct. The worst mistakes in business plans are often in the marketing design. These mistakes occur because of two reasons: firstly, you must put yourself into your future customers' shoes, and adopt their way of thinking and their emotional attitudes, which is not easy and often does not receive enough attention. Secondly, there are many market factors that you cannot influence directly: for example, the key question – How many customers will buy our product? – can never be answered accurately in advance, but at best be approximated. Nevertheless, rigorous analysis of the market and the competition can significantly improve the quality of your forecasts.

It makes sense to prepare the marketing plan in three stages:

1. **Analyze the market and the competition:** at this stage you become more familiar with the market for your business idea, and analyze the strengths and weaknesses of your competitors.
2. **Choose your target market:** here, you choose the group of customers ("customer segment") whose needs your product meets best, and to whom you have the most to offer, compared with the competition. You also define how you want to distinguish yourself from the competition ("positioning through differentiation").
3. **Determine your marketing strategy:** at this stage you determine how you will reach and address your customers, with specific measures covering product design, pricing, distribution and communication.

If there is
no competition,
there is probably
no market.

Brian Wood

MARKET AND COMPETITION

A thorough knowledge of customers and their needs is the basis for any business success. The customers provide your company with its raison d'être, and decide on its success or failure by buying — or not buying — your product or service. Customers will only buy your product if they believe it offers them greater benefit than buying a competitor's product.

Market size and growth

You should have some initial estimates of market size, in terms of number of customers, the number of units and the total sales in guilders. When preparing the analysis, note the difference between an existing market and an entirely new market. If you are bringing out an improved version of a product that is already available on the market (such as a more effective toothpaste) these figures will be fairly easy to get hold of. You will find data in the trade publications, or receive them from public authorities or trade associations. Check your data for plausibility. Ideally, you should forecast the growth of the market over the next five years, using the rates for the past five years for comparison.

The market size is more difficult to estimate if you are starting with something completely new. In this case, you will have to derive the figures from the number of potential customers or customer segments. You will probably need to do some market research yourself, using a small questionnaire. Alternatively, you could conduct some interviews with experts on the subject or with people most likely to become your customers.

How to make an accurate estimate

Estimating is an important part of the planning and decision-making processes. This applies to both the start-up and the growth phases of businesses. Stick to the following principle: “It is better to be approximately right than precisely wrong”. It is better to produce a roughly accurate estimate, than to calculate to several decimal points a supposedly exact figure that cannot possibly be right given the uncertainty in the assumptions. This applies in particular to estimates of the size of a market or customer segment.

Some helpful hints when estimating:

- ❖ **Start from a solid basis:** there may be many unknowns, but if you use easily verifiable figures as a basis, you will build your estimate on solid foundations
- ❖ **Follow a logical path:** the logic of an estimate should be clear – there should be no breaks in the chain or unspecified assumptions
- ❖ **Compare your sources:** wherever possible, check information, such as statements in an interview, against other sources
- ❖ **Be creative:** the shortest distance is not always a straight line. For example, if one value is unknown, try to find a substitute value that relates to the one that is missing
- ❖ **Check for plausibility:** for every estimate always ask yourself: “Does the result actually make sense?”

A sample estimate

How many disposable diapers are currently used per day in the Netherlands?
Possible procedure:

- ❖ **Basis:** the population of the Netherlands is 15.6 million (Centraal Bureau voor de Statistiek)
- ❖ **Assumption:** an average child wears diapers for 2 years (ask parents)
- ❖ **Basis:** average life expectancy in the Netherlands is 77 (geography textbook)
- ❖ **Calculation:** at a rough estimate, the number of Dutch diaper-wearing children is $2/77 = 2.6\%$ of the population, or 405,000 children
- ❖ **Refinement of assumption:** the population is not distributed evenly across age-groups, since the current birth rate is relatively low and the number of people per age group decreases with increasing age. We assume that these effects roughly cancel each other out, and account for this uncertainty by choosing a range of 385,000-425,000 diaper-wearers.
- ❖ **Assumption:** daily consumption of diapers (ask parents again): 4-6 diapers
- ❖ **Result:** estimated average daily consumption of diapers in the Netherlands = **1.5-2.6 million**

Actual figure: 2.0 million

Know your competitors

Anyone offering something in a market will have to face competitors. If you are to challenge the competition successfully, you will need to find out who the most important suppliers in the market are, what their market share is, how they operate, and what their strengths and weaknesses are. Also you will have to try and estimate whether, and if so how quickly and at what cost, another supplier with a similar product could enter the market, and what effect that would have on the success of your business. Make clear that you understand the competition. Name your competitors specifically, and describe why and how your company will be better.

There is competition in everything. Take into account existing or potential direct competitors, but also think about substitutes. Substitutes are products that provide the same customer benefit in a different fashion. When Sony and Philips brought out the CD, there was at that time no direct competition from other digital sound systems. At first, the CD was competing with existing analogue products — records, tapes and cassettes — as well as with entertainment media in a more general context. However, other digital systems very soon appeared, followed by new CD formats.

Competitors can also create an opportunity. In some cases selling your venture to a competitor or a major customer might be a good alternative for an initial public offering. For example, a year after the introduction of WebTV Internet terminals, WebTV was acquired by Microsoft.

CHOOSING THE TARGET MARKET

Your business idea will not be of equal interest to all customers, because they do not all have the same needs. Therefore, you will have to identify those customers within the total market who will benefit most from your product or service, can best be reached by you, and are ready to pay for it. In marketing language, you must choose your “target market” and define its characteristics.

Your marketing plan should contain statements of the total market, your target market and market share. You should also estimate the future development of these segments.

Your marketing plan must answer four questions:

- ◆ Who are your customers or customer groups (“segmentation”)?
- ◆ Which customers or customer groups are particularly attractive financially?
- ◆ How can you differentiate yourself from the competition (“positioning”) for these attractive customers?
- ◆ What market share and what level of sales do you expect to achieve with these customers?

Who exactly are your customers?

With your product or service, you intend to meet a customer need — as accurately and efficiently as possible. Since it will usually not be economically viable to tailor your product and publicity to each individual customer, you must apply appropriate criteria to group your potential customers. In marketing language, this is called “customer segmentation”. Criteria are appropriate if they produce customer groups that are as internally consistent as possible, but large enough to allow you to serve them efficiently. The criteria must also be applicable to product design, pricing, publicity and distribution. This is no trivial matter. Purchasers of TV sets, for example, could be segmented into those with blue, brown or green eyes — but what would be the point? If, on the other hand, you find out that young people with low incomes (e.g., students) prefer small, portable TVs

with stereo sound and a price tag of less than Dfl. 600, you may have defined a useful target segment.

Customer segmentation has two purposes. First, it helps define the market that your product can reach. One of the greatest marketing mistakes is to overestimate or underestimate the actual market. If, for example, you were bringing out a new type of toothpaste, you might start from the assumption that all the inhabitants of the Netherlands are potential customers. More rigorous analysis might, however, reveal the following picture: 50% are out of the question as consumers, because they buy their toothpaste from the major retailer you cannot supply. Of the remaining consumers 40% buy on price – the fact that your toothpaste cleans teeth better matters less to them than the price – you lose them because your toothpaste is more expensive than the products of your competitors'. Of the remaining 30% of the total population, you lose a third because your toothpaste is unsuited for the elderly. The actual market for your toothpaste is therefore just 20% of the total market.

Sample customer segmentation criteria

For consumer goods

1. Geographic: country (the Nederlands, Belgium, Germany, etc.) or population density (urban/rural, etc.)
2. Demographic: age, gender, income, profession, etc.
3. Lifestyle: technofreaks, the environmentally conscious, Generation X, etc.
4. Behaviour: frequency of usage, application of product, etc.
5. Purchasing behavior: brand preference, price consciousness, etc.

For industrial goods

1. Demographic: company size, sector, location, etc.
2. Operational: technology employed, etc.
3. Purchasing behavior: central or decentral purchasing, contracts with suppliers, etc.
4. Situational factors: urgency of need, order size, etc.

Second, customer segmentation helps you design a specific – and thus more effective – marketing strategy for each customer segment. Different customer segments may be interested in your product for quite different reasons. Children may like your new toothpaste because of its taste, parents because of its greater effectiveness against decay. If consumers are segmented into uniform groups by these preferences, measures can be taken to “position” the product effectively with each customer segment. You will find much more on marketing strategy in the next sections of this chapter.

Choosing the target segment

Once you have divided the market into individual customer segments, you will have to consider which segments to concentrate on. The aim is not to serve all segments, but to concentrate on those that promise the greatest profit, now and in the future.

Various criteria are useful in reaching a decision here:

- ◆ Size of the segment
- ◆ Growth of the segment
- ◆ Match between product and customer needs in a segment
- ◆ Potential for differentiating your own product against competing products.

Positioning vis-à-vis competitors

Why should a potential customer buy your product rather than that of one of your competitors? Because it offers the customer more than the competing product does; because it is “better”, either rationally or emotionally. Or as marketing specialists would put it, because you have developed a Unique Selling Proposition (USP).

Formulating a USP and anchoring it firmly in the minds of your customers is the key task of marketing communication. Marketing experts talk about the positioning of a product, a brand or a business. Well positioned products always make a particular impression on consumers when they think of them. This is why the most important guideline for positioning is: adopt the customer's perspective; the idea is to find a better way to

meet their needs, not to present a product's new attributes. Customers must be able to grasp immediately why your product is better in a way that matters to them. At the same time, your positioning should be readily distinguishable from that of your competitors. Only if this is the case will they associate the additional benefit that you are offering with the name of your product or company, and so buy your product.

Because the positioning of your product is so important for market success — and consequently for the long-term success of your business — you should pay a lot of attention to it. A convincing positioning will not come about of its own accord; it will require a good deal of effort, and will need to be revised continually to achieve maximum effect. A point of departure for the positioning is the product idea itself. You will get additional insights as you refine and modify your product in the course of its development, as you bring it closer to your customers' needs.

The path to successful positioning

- ❖ Identify relevant customer needs or problems
- ❖ Define clear customer segments of sufficient size
- ❖ Design an attractive proposition in terms of products or services
- ❖ Define your uniqueness by differentiating against the competition
- ❖ Address the subjective perception of your potential customers
- ❖ Ensure customer satisfaction after the purchase too.

Market share and sales volume

One of the key questions in business planning is what market share and sales volume you can reach within the first five years. Your considerations on positioning will give you some useful indications of how many customers you could reach in the various segments. You should also consider whether you will be able to win away customers from the competition, and, if so, how many. Wherever you offer the maximum benefit, you will win the most customers. But be realistic!

MARKETING STRATEGY

A strategy describes the approach to achieve an objective. The marketing strategy defines the measures you will employ to reach the objectives set out in the marketing plan — which will result in sales. Generally speaking these measures can be grouped under the “4Ps” of marketing: Product, Price, Place and Promotion.

- Product:** what characteristics must your product have to meet the relevant customer needs?
- Price:** what price can you ask for your product, and what goal are you pursuing with your pricing strategy?
- Place:** how are you going to reach customers with your product?
- Promotion:** what means of communication will you use to convince your customers of the benefit of your product?

Product: product characteristics

Your original product idea has already given you some sense of the characteristics of your product. Now that you have made a closer analysis of the needs of various customer segments, you must consider whether your product really meets them, and to what extent it may need to be adapted. This raises the question of whether you should produce a standard product for all segments or adjust the product to meet the needs of particular segments.

Price: pricing

With your positioning, you have decided how you will differentiate your product against the competition – this includes pricing. Specifically, you should answer the following questions:

- ◆ What price can you ask?
- ◆ What pricing strategy will you adopt?

What price can you ask?

The price you can ask is the price the customer is prepared to pay. This contradicts the widespread opinion that price is determined directly by cost. Of course cost is a factor, but the cost/price ratio only becomes critical when the price that can be asked does not cover the costs. This, by definition, means the business is unattractive. Cost naturally also plays a role because the difference between cost and price defines the profit – and the ultimate goal of any commercial enterprise is to maximize profit.

The price you can ask depends entirely on how much the benefit of your product or service is worth to the customer. You have defined, and perhaps also quantified, the customer benefit in your business idea or product description. Now you should define a price bracket, using the method shown in the “Pricing by Customer Benefit” box below. You can verify and further refine your assumptions in discussions with potential customers.

What pricing strategy will you adopt?

Your pricing strategy depends on your goal: do you want to penetrate the market quickly with a low price (“penetration” strategy), or do you want to get the highest possible return right from the start (“skimming” strategy)?

Pricing by customer benefit

(*value-based pricing*)

Previously, when a telecommunications company wanted to increase its transmission capacity, it had to lay new cables. Depending on the conditions, the excavation work cost Dfl. 50–100 per meter. Accordingly the cost of 50 km of new cable was Dfl. 2.5–5 million.

As an alternative, Ciena Corporation offers electronic equipment that extends the capacity of existing glass fiber cables by wavelength multiplexing. Instead of using a single beam, light is sent through the cables as several colors of different wavelengths. Each color carries as much information as the entire original beam. Equipment that will multiply the transmission capacity by 24 costs Ciena Corporation about as much to manufacture as a well equipped PC. What price can be asked to cover the development costs and, above all, reflect the benefit of the idea? Ciena Corporation offers the system with 24 channels for Dfl. 2.5 million, at the lower end of the average cost of laying 50 km of cable with other technologies.

There are usually good reasons for new companies to pursue skimming strategies:

- ◆ The new product is generally positioned as “better”, so its price can also be higher.
- ◆ Higher prices generally produce higher margins, thus enabling the new company to finance its growth itself. New investment can be financed out of profit, and there is no need for additional outside investors.
- ◆ Unlike a skimming strategy, a penetration strategy generally requires high initial investments to produce supply adequate to meet the high demand. Whenever possible, investors prefer to avoid this additional investment risk and adopt a skimming strategy, retaining the option to adopt a more aggressive approach when appropriate.

A penetration strategy may be appropriate in the following cases:

New standard: when Netscape, for instance, distributed its Internet browser for free, it was able to set a new standard. Apple, on the other hand, followed a skimming strategy with the Macintosh, and thus missed the opportunity of establishing it as a standard.

System-related: businesses with high fixed costs must find a large number of customers very quickly if they are to be profitable. FedEx is the classic example: air transport and sorting offices require similar investments, whether the company moves thousands or millions of letters.

Competition: low entry barriers make strong competition likely. A penetration strategy is the best way of securing a large market share more quickly than the competition. However, this raises the question as to whether a business of this sort is appropriate at all for a start-up company.

Place: distribution

Your product or service must actually reach the customer. Behind this simple statement lies an important marketing decision. In what way — via what “distribution channel” — will you distribute your product? Various questions will influence your choice of distribution channel. For example: How many potential customers exist? Are they companies or individuals? How do they want to acquire the product or service? Does your product need to be explained? Is it in an upper or a lower price bracket? You will have to make a basic decision as to whether your company will do the distribution itself, or have it done by a specialized organization instead. This sort of “make or buy” decision will have a significant effect on the organization and business system of your enterprise (see Chapter 5, Business system and organization). The choice of distribution channel is thus closely related to other marketing decisions, and affects other measures you will take.

Typical gross margins

Gross margins vary from business to business, and they depend on various factors. For example:

- ◆ The competitive situation in the market (strong competition produces low margins)
- ◆ The entrepreneur's business efficiency (improves the margins)
- ◆ The complexity of the product (increases margins), the quantity, throughput time and stock levels (the higher the number of units and the shorter the throughput time, the lower the margins).

Retail trade

| | |
|--------------------------------|-----|
| Pharmaceuticals | 35% |
| Textiles | 40% |
| Sports goods | 35% |
| New cars | 15% |
| Groceries (Supermarket chains) | 20% |

Wholesalers

| | |
|---------------------|-----|
| Packaging materials | 25% |
| Textiles | 25% |

Manufacturers

| | |
|------------|-----|
| Printing | 55% |
| Publishing | 60% |

The distribution channel: gateway to the customer

Technological developments, particularly in information technology, have greatly expanded the spectrum of distribution channels over the past years. Here is a selection:

Third-party retail businesses: products are sold via retailers with good access to potential customers. It is important here to get a good shelf position, which is obviously also sought by the competition, and accordingly expensive. The product must also offer retailers an attractive profit if they are to include it in their range at all.

Outside agents: specialized companies act as agents for the distribution of the products of various manufacturers. Outside agents are relatively expensive, but only for the sales they actually make (if they make no sales they receive no commissions). This makes them an attractive channel for new companies, as the risk is limited. However, good agents are not always easy to find.

Franchising: a business idea is put into practice independently by a franchisee, on payment of a license fee (McDonald's is a well known example of this approach). The franchiser maintains control over the brand strategy and product decisions. Franchising enables rapid geographical growth and control of the distribution concept with limited investment.

Wholesalers: a small company may find it difficult to maintain contacts with a large number of retailers. Wholesalers with good retail trade contacts can fulfill this function. They can help improve market penetration and reduce distribution costs. But wholesalers also require a margin for their efforts.

Own outlets: own-outlet distribution will be the choice when the design of the "purchasing experience" is of particular importance for the product, and only a small number of outlets is required to cover the market. Own outlets require investment, but offer the best control over distribution.

Own sales agents: these are mainly used for complex products (e.g., investment goods), which require knowledgeable sales staff. Personal visits to customers are time-consuming and expensive, so the number of customers must be relatively small. Own agents are comparatively expensive as a distribution channel, and are only worth considering for high-value products.

Direct mail: selected customers receive advertising material directly by mail. Good databases are available in most countries, selling addresses sorted by specified criteria (e.g., women from 40-55 years old, unmarried, working, with an income over Dfl. 60,000). The success of direct mail depends on making an immediate appeal to the customer, otherwise the direct mail will end up in the wastepaper basket.

Call center: customers are invited in the advertising material to order a product by phone. This is a way of getting simple products to customers without having shops throughout the whole sales area. You can also contract call center services from specialist operators, who receive the orders and forward them to you.

Internet: the Internet is a relatively new marketing channel. In principle, a global market is accessible at minimal cost. The Internet is still only used by a limited, though rapidly increasing, number of potential customers.

Promotion: communicating with the customer

Your potential customers must know about your product before it can attract their interest. You must advertise in order to get noticed, provide information, persuade and create confidence. You must explain to your customers the advantages, or the “customer benefit”, of your product or service. You must convince them that it meets their needs better than competing products or services, and also better than any alternative solution. There are various ways of getting your customers’ attention:

- ◆ Classic advertising: newspapers, magazines, specialist publications, radio, TV, cinema
- ◆ Direct marketing: direct mail to selected customers, telephone marketing, Internet
- ◆ Public Relations: articles about your product, company, you personally, in the print media, written by you or a journalist
- ◆ Exhibitions, trade fairs
- ◆ Customer visits.

Communication is expensive, so make the best possible use of it. Work out exactly how much advertising you can afford per sale, and select your communication media accordingly. Focused communication yields better results.

When you address your customers, concentrate on the people who actually make the buying decision. In most families, the wife makes most purchasing decisions. In companies, purchasing departments make most decisions themselves, or they make recommendations which usually amount to preliminary decisions.

Sample advertising costs

The cost of a campaign depends on many factors. For example, is it a new product? Is it known, and should it arouse sympathy? Which segments should be addressed? What are the segments’ communication preferences? A national campaign could use any of the listed media.

| Media | No. of outlets | Type of ad. | Typical number per outlet | Cost, Dfl. |
|---------------------------|------------------------|-----------------|---------------------------|------------|
| Daily national newspapers | 8 titles | Full page b/w | 6 ads | 2,000,000 |
| Daily regional newspapers | 10 titles | Full page b/w | 6 ads | 900,000 |
| Weekly newspapers | 6 titles | Full page b/w | 4 ads | 96,000 |
| Business press (managers) | 8 titles | Full page b/w | 4 ads | 450,000 |
| Mass-market magazines | 10 titles | Full page color | 4 ads | 760,000 |
| Dutch TV | 3 (Ned, RTL4 Veronica) | 30-sec. spot | 28 ads | 970,000 |
| Cinema | 175 cinemas | 30-sec. spot | 2 week-period | 92,000 |
| Local radio (local areas) | 20 stations | 20-sec. spot | 40 ads | 1,300,000 |
| Bill boards | 1,600 sites | Abris | 2 week-period | 175,000 |

Marketing checklist

Does your business plan answer the following questions?

- Is the Unique Selling Proposition formulated precisely and from the customer's perspective?
- Who are your competitors? What substitutes are available for your product?
- Which customers make up your target segment? Why is this segment particularly interesting for your company?
- How large is the whole market? How large is the market you are interested in? How will it develop?
- How do you expect your market share and your sales volume to develop?
- What price are you asking?
- What distribution channel(s) will you use?
- How much will your advertising cost?

5. Business system and organization

With the marketing plan, you have defined the purpose of your enterprise from the customer's perspective. Now you must actually realize the customer benefit. You have to decide what separate activities are necessary, and how they can be combined into a "business system". All the steps involved in manufacturing the product or providing the service must be performed systematically and cost-efficiently as part of a coordinated process. Only then will there be economic benefit for both customers and the company. For a business system to be able to function, it must be clear what it contains and how the various elements interact. Organizational aspects include the allocation of tasks and responsibilities, personnel planning, management and corporate culture. Of practical importance is the question as to which activities the company will perform itself, and which products or services it will obtain from third parties ("make or buy").

In this chapter you will find out:

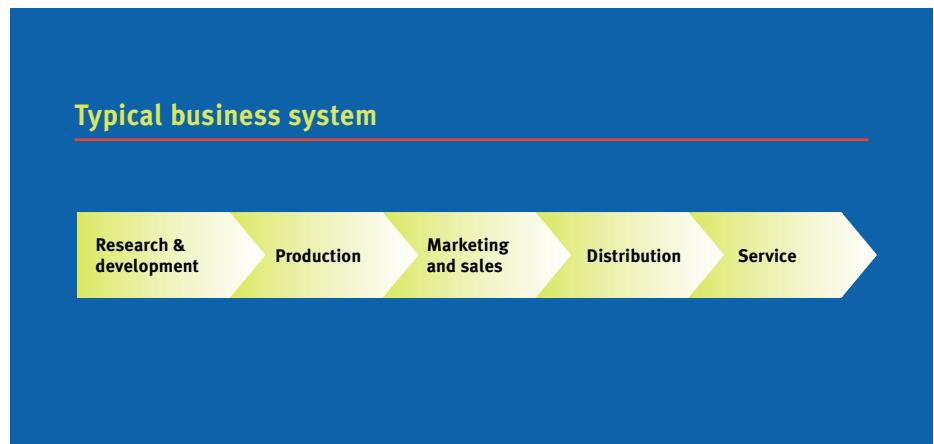
- ◆ What a business system is, and what to look out for when designing one
- ◆ What organizational questions you will need to answer
- ◆ What to take into consideration when thinking about producing yourself or leaving it to third parties, and about partnerships.

What tips me off that a business will be successful is that they have a narrow focus of what they want to do, and they plan a sufficient amount of effort and money to do it. Focus is essential.

Eugene Kleiner

THE BUSINESS SYSTEM

Any entrepreneurial task is made up of a combination of separate activities. When they are represented systematically in relation to one another, the result is a “business system”. The business system describes the activities that need to be performed to produce a product and deliver it to the customers. For clarity’s sake, these are grouped in functional blocks. A typical business system, common to almost all industries and enterprises, is shown below.



The business system is a good way of understanding the business activities of a company, thinking them through systematically, and representing them clearly.

From a typical business system to a specific one

Take the typical model as a starting point for designing your own business system. To be able to put it into practice, you must apply it to your own specific situation. For a manufacturing company, for example, it makes sense to subdivide the production stage into purchasing, raw material processing, component production and assembly. It may also be necessary to subdivide the distribution stage into logistics, wholesale and retail.

The appropriate business system will depend largely on the sector you are in and, of course, on your company itself. A computer manufacturer's business system will be very different from that of a fast food chain. But a department store's business system will also look quite different from that of a direct distribution enterprise, although they may sell the same products. There are no generally applicable rules or standards for business systems: yours should be logically structured, complete and helpful in your planning. But don't let it get too complicated!

Focus, focus, focus

One of the key questions that need to be answered when designing a business system relates to which tasks and activities the business should concentrate on, and which tasks it should leave to others, be they suppliers, clients or business partners. A team of three to five people will not be able to perform all the tasks themselves — either because they lack the skills, or because they cannot do them with the necessary efficiency. So, get together with your management team and think hard about those activities that are really creating something new, and how you and your staff can make the best use of your time to create the greatest benefit for your customers, and thus get ahead of the competition. The key word is focus: once you understand the stages of the business system, choose to perform those activities yourself that you can do better than anyone else. The trend to specialization can be clearly seen in a wide range of industries.

When Henry Ford started making cars, it was his intention to carry out every stage of the business system himself. He even bought large forest tracts to provide the necessary wood for the Model T chassis. Today, Ford concentrates on only a few stages of the business system, namely development and marketing. Production for Ford is now no more than final assembly, with all other production stages being carried out by subcontractors. Sales, distribution and service are in the hands of independent dealers.

Specialization is particularly important for start-ups: they need to concentrate all their energy on a few stages in the business system. Even Microsoft, now a software giant, started by concentrating exclusively on the development of the DOS operating system; all the other functions of the business system, including production, distribution and marketing of DOS, were carried out by IBM.

The CityScape case illustrates the focus and the business system of an Internet company. CityScape concentrates on the production of content for the Internet and on marketing. For the infrastructure it needs, CityScape relies entirely on the services of other companies — for example, telephone companies for data transmission and Internet service providers, like Planet Internet or CompuServe, for technical access to the Internet.



Organizations exist to enable ordinary people to do extraordinary things.

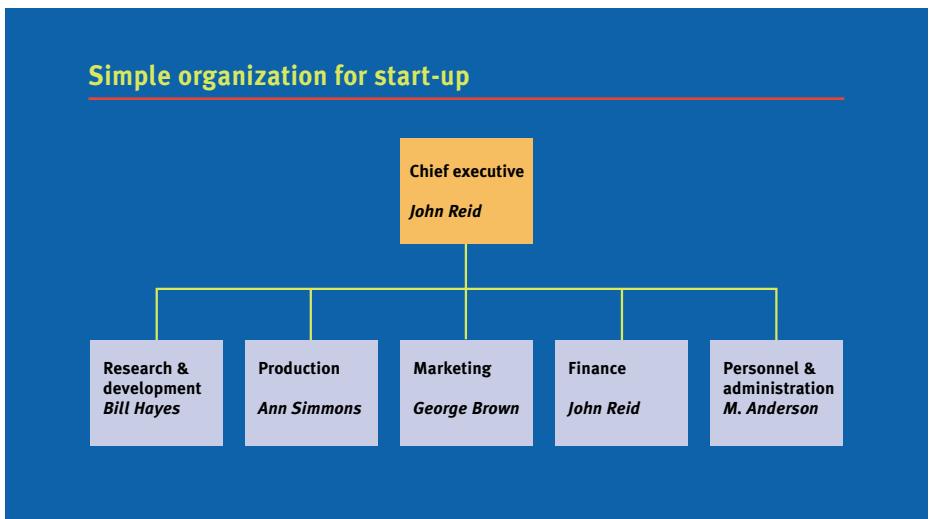
*Ted Levitt
Editor, Harvard Business Review*

ORGANIZATION

In addition to the business system, you will need to consider several organizational issues. For a start-up, it is not necessary to draw up a complicated blueprint of the whole organization. What really matters to begin with, is that the responsibilities are clearly allocated, and that you design a simple organization with only a few levels: chief executive, heads of department, departmental staff. Everything else will be dictated by the requirements of the business activities. Your organization must be flexible, and always able to adapt to new circumstances — you should expect to have to reorganize your company several times in the first few years.

An effective organization

When you were putting together your “dream team” (see Chapter 3, Management team), you already started thinking about the work your company would do and the way it would do it. This was the basis for the “competencies” your company would need. You can now use the business system to group them into appropriate areas. For each area, you should define who is responsible for what (allocation of tasks and responsibilities). Once you have set up cross-area functions, such as an executive committee, personnel management, finance and adminis-



Sample personnel costs

Personnel costs depend on a wide range of factors, for example, the sector, the age and capabilities of the employee. Here are some typical values:

| Function | Annual salary,Dfl. |
|------------------------|--------------------|
| Chief executive | 200,000 |
| Commercial manager | 120,000 |
| Computer programmer | 95,000 |
| Administration manager | 90,000 |
| Electronic engineer | 80,000 |
| Systems manager | 75,000 |
| Personnel manager | 75,000 |
| Chemical analyst | 65,000 |
| Laboratory assistant | 55,000 |
| Accounting assistant | 50,000 |
| Metalworker | 45,000 |
| Graphic designer | 40,000 |
| Receptionist | 35,000 |

Employers' contributions beyond wage and salary costs (supplementary wage costs) amount to 75-80% of the wage costs.

tration, you will have an organization that is ready to run. If you keep the organization simple, you will ensure that each member of the team takes on clearly defined tasks and carries them out independently. A certain amount of coordination is of course necessary, to allow for both integrated actions and to be able to fill in for a missing team member on short notice.

Personnel planning

With the rapid growth of the new company, systematic personnel planning becomes essential. Growth requires more people: new staff must be recruited, integrated into the organization and trained. A clearly structured working environment will help you produce clear job descriptions and search for the right new people. You should be aware that qualified specialist personnel is not easy to find in the Netherlands, even in times of high unemployment. You will often be forced to attract good people from your future competitors — given that notice periods extend to about two months, you will need to plan ahead accordingly.

Values

As well as giving thought to the formal aspects of the organization, you will also need to consider the “soft” factors. Like all communities, enterprises develop their own patterns of conduct, and these influence the behavior of the entire organization and of the individuals who make it up. The term generally applied to these standards and values is “corporate culture”. The values derive mostly from the management team and its vision, and they may be explicitly formulated. What matters, though, is that they are “lived” — by everyone. Elegant “Guidelines” in a golden frame alone will do no more than relieve the conscience. If, however, you manage to develop a corporate culture that radiates both internally and externally, you will find this to be a competitive advantage. Values make a company attractive to outstanding staff in the long term. Corporate culture in a broader sense may also include issues concerning salary and incentive systems (e.g., share options or a performance-related bonus).

Examples of standards and values

- ◆ We are always there for our customers
- ◆ We preserve our integrity, even if this is to our financial disadvantage
- ◆ We rely on team performance, not individual performance
- ◆ We want to be the biggest and the best
- ◆ We reward outstanding performance
- ◆ We regard our staff as our most valuable resource
- ◆ We intend to be market leaders
- ◆ We strive for the highest quality in all that we do.

The right location

In some circumstances the right location can be a decisive factor in the success of a business. It will matter more or less depending on the activity involved. Some classic location factors are:

- ◆ The legal environment: liability legislation, taxes
- ◆ The political environment: ownership guarantees, extent of regulation
- ◆ The economic environment: economic climate, unemployment, land price, rents
- ◆ Proximity to purchasing or sales markets (depending on product)
- ◆ Access to specialist personnel and skills (now the key factor in most sectors).

In view of your anticipated growth, you must expect your business to move its location several times in the first 5 years. So avoid long-term rental contracts and look for flexibility when choosing accommodation.

Sample accommodation costs

The amount of space you will require depends directly on the activity involved. Costs for office and industrial space vary widely according to the location.

| Average rental for office accommodation | Dfl. per m ² per year |
|---|----------------------------------|
| The Netherlands | 175–250 |
| The Randstad conurbation | 200–350 |
| Amsterdam | 225–500 |

| Space required | m ² per person |
|--------------------|---------------------------|
| Open-plan offices | 9–10 m ² |
| Individual offices | 15–20 m ² |
| Managers' offices | 25 m ² |

| Average rental of industrial accommodation | Dfl. per m ² per year |
|--|----------------------------------|
| The Netherlands | 45–115 |
| National airport (Schiphol) | 80–165 |

Source: DTZ Zadelhoff

“MAKE OR BUY” AND PARTNERSHIPS

When you have determined the core activities of your business, and laid out the necessary business system, you will have to decide who will best carry out the individual stages. Activities outside the chosen focus should be assigned to third parties. Also, supporting activities within the new company need not necessarily be performed by the company. These include, for example, accounting or personnel management. For each individual activity, the same basic question should be asked: “Do it ourselves or have someone else do it?” — or in business jargon: “Make or buy”?

Make or buy

“Make or buy” decisions should be made deliberately, after considering all the advantages and disadvantages. Partnerships with suppliers, for example, often cannot be dissolved from one day to the next, and many partners are hard to replace if they drop out. When making your “make or buy” decisions, you should rely mainly on the following criteria:

Strategic importance: your ability to render a specific service better than the competition was a major factor in your decision to start a company in the first place. This service is of “strategic” importance to your company, and should be kept under your own control. A technology company would never let go of research and development, and a manufacturer of consumer goods will never hand over marketing to a third party.

Best provider: any entrepreneurial activity requires specific skills that may not be available within the management team. Your management team must therefore consider whether, in specific instances, it makes sense for the company to carry out a particular task itself. Should the company want to acquire the necessary skills, or would it be more advantageous to assign the task to a specialized supplier? For example, a team developing some electronic equipment has mastered the electronics, but it lacks the necessary manufacturing capability — so it would do better “buying” this task. Their experience often enables specialist

companies to perform a task better, and more cheaply, due to their higher production volume.

Availability: before you can make a decision to buy, you need to find out whether the product or service is available on the market in the desired form or with the necessary specification. Whenever possible, negotiate with several suppliers: you generally end up with better terms, and you will also find out more about whatever you are purchasing. You can also often help a supplier improve an offer. If you cannot find a supplier for what you need, you may be able to find a partner who is prepared to develop the necessary skills.

Partnerships

Any company has business relationships with other companies — as a purchaser, as a supplier, or as an equal business partner. These relationships vary in their quality and intensity, from a loose, more or less coincidental relationship (a company buys its office supplies from the supermarket with the cheapest range) to a strategic alliance that results in intensive cooperation and mutual dependency (e.g., Microsoft and Intel in the 1980s). Exchanging ideas and people with a partner, and jointly developing products or components can prove to be very fruitful.

For a start-up company, the question of how to work together with other companies is particularly relevant. Every type of cooperation has advantages and disadvantages:

- ◆ Loose, casual partnerships represent no great obligation for either side. Both partners can end the partnership quickly and simply; both, however, also live in the knowledge that supply or demand can dry up quickly. Furthermore, a supplier will not take much notice of a customer’s particular requirements, as he will not be able to sell individually-adapted products to his other customers. Loose relationships are thus typical for mass-market products, undemanding services and standard components, for which replacement suppliers and purchasers are easily found.

- ◆ Close partnerships are characterized by a degree of tight interdependence between the partners; they are typical for highly specialized products and services, or for large volumes. In such situations, it is usually difficult for both sides to change partners at short notice, to obtain large quantities of specialized components quickly from another supplier, or to find a market for such components. The advantage for both sides is the security of a firm relationship and the possibility of concentrating on one's own strength, while also profiting from the partner's particular strengths.

For a partnership to develop into a successful business relationship various elements need to be in place:

“Win-win situation”: both sides must get fair shares of the advantages of the situation; without an incentive for both sides, the partnership is not viable in the long term.

Balance between risks and investments: partnerships involve risks, and often not enough attention is paid to these risks, particularly when business is good. A supplier with an exclusive contract can find himself in a difficult situation, for example, if his customer suddenly cuts back production and purchases fewer components. This is even more the case if the supplier has purchased special production tools which cannot easily be used for other customers' orders. Conversely, a customer can find himself in serious difficulties if a supplier cannot deliver (on account of bankruptcy, fire, strike, etc.). Risks and their possible financial consequences need to be taken into account in advance and, if necessary, considered in the contract.

Dissolution: just as in human relationships, tensions can arise in business relationships. Make sure that in any partnership, the conditions under which the partnership may be dissolved or one partner may withdraw are clearly defined from the start.

While working on the business plan, start thinking about who you will cooperate with later, and what form this cooperation will take. Partnerships offer your new company the chance to profit from the strengths of established companies, and to concentrate on building up your own strengths. In this way, you can usually grow faster than you could on your own.

Checklist for business system and organization

Does your business plan answer the following questions?

- What does your company's business system look like?
- What activities within the business system will the company perform and which will it buy in (“make or buy”)?
- What are you focusing on?
- What entrepreneurial functions make up your organization, and how are they structured?
- What values and standards characterize your organization (corporate culture)?
- What partners will you work with? What are the advantages of this cooperation, for you and for your partners?

**Business is
like chess:
To be successful,
you must anticipate
several moves in
advance.**

Professor William A. Sahlmann

6. Realization schedule

Realistic planning is not easy. This is particularly true when you have little experience in building up a business, and even more so when no-one has had any experience with your particular business idea — which is a normal start-up situation. Don't let the thought that your plan will be rapidly overtaken by reality stop you from planning as realistically as possible, for failure to plan is very likely to have fatal consequences for your business.

The realization plan has a significant influence on the financing and the risks of your business. So you will be helping both yourself and your partners if you think the interactions through in advance, and analyze the effects of the various influences.

Planning is a tool – use it! In this chapter you will find out:

- ◆ How you can plan better
- ◆ What the consequences of faulty planning can be
- ◆ How to present your planning in the business plan.

The seeds of every company's demise are contained in its business plan.

*Fred Adler
Entrepreneur*

PLANNING EFFECTIVELY

Effective planning has an organizational and procedural aspect. Four simple rules will guide you here:

1. Break tasks down into “work packages”

Building up an enterprise involves a great deal of detailed work, which makes it even more important that you keep an eye on the whole. You can make things simpler by grouping individual tasks into work packages. The business plan should not, however, contain more than a dozen of these packages — the people concerned can subdivide their own packages further if they wish. Break each package down into simple steps, each of which should end with a “milestone” — a specific target.

2. Get advice from experts

Make use of expert knowledge when working on the important planning stages. By definition, there will be no expert for the entire business, but there will be for the individual stages. For example, a marketing specialist can tell you how long it takes to design and carry out a marketing campaign. If the time suggested by an expert does not agree with your own ideas, question the assumptions: what needs to be changed to move forward more quickly? But remain realistic about this.

3. Follow the critical path

All overall planning consists of a series of events (some sequential, others parallel) which are more or less closely interconnected. The series of activities in which a delay of any one activity means a delay for the entire project is called the “critical path”. Obviously, you should pay particular attention to activities on the critical path: if you are looking to save time, you will have to find some way of streamlining the activities on the critical path.

4. Reduce risks

Whenever possible, try to reduce risks at the earliest possible stage. For example, you could carry out market research early on and not wait until you are almost ready to enter the market. If early market research reveals that your business idea has real potential, you can use this information in planning the build-up of your business.

Why realistic planning is important

1. You gain credibility with investors and partners
2. You increase your enterprise's chances of success by thinking through the various activities and their interrelationships
3. You will endanger your company if you adopt the wrong – and in particular, too optimistic – targets. You risk losing your stake in the company.

POSSIBLE CONSEQUENCES OF FAULTY PLANNING

When planning, you always have to start with assumptions. There is always the danger that they will be too optimistic or too pessimistic. Both errors can have serious consequences for the future of your enterprise.

Consequence of optimistic planning

Over-optimistic planning puts you in double jeopardy. On the one hand, you will rapidly lose credibility with your partners. On the other, over-optimistic planning can easily result in the failure of a new enterprise a little further down the line. Here's what could happen:

- ◆ Resources – material and human – are built up rapidly, according to plan, and costs rise accordingly. The jargon term for this is a high “burn rate” – the money is used up very quickly.

- ◆ Some delay occurs, perhaps in product development, market entry, or in reaching sales targets. Income is delayed, while at the same time the costs of under-utilized resources are rising. The enterprise is not just posting book losses, it is losing cash.
- ◆ Inevitably, the money runs out before the planned success is achieved. New funds are needed, in an emergency situation to save the company.
- ◆ If no investors can be found, the enterprise fails. If there are investors who still believe in its success (which is doubly unlikely after the loss of credibility due to faulty planning), they will provide further funds. However, for the entrepreneurs this often means a painful reduction in their share of the company, and perhaps even the total loss of their equity.

Consequences of pessimistic planning

At first glance, pessimistic or conservative planning seems the lesser evil. You and your partners will be pleasantly surprised by your progress, and everything will go better, and happen more quickly than expected. However, pessimistic planning can have just as serious consequences, as shown in the following two scenarios:

- ◆ The business takes off, but the necessary resources are lacking. One option is to try and meet the demand with the available resources, but this is bound to produce quality problems that will put the long-term success of the enterprise at risk. An alternative is to grow according to plan, in the knowledge that potential sales are being lost, and with the risk that a competitor will enter the business. In any event, significant value-added is lost, for both entrepreneur and enterprise.
- ◆ The business grows more quickly than expected. However, growth requires liquid assets (cash) and usually investments in production. The company quickly runs out of money, although it is posting book profits. The entrepreneur therefore needs to find additional funds earlier than planned, under time pressure and on unattractive terms. This road leads to insolvency: you can literally “grow yourself bankrupt”.

Be honest with yourself in your planning, and try to be as realistic as possible. Take account of uncertainties by presenting risks openly and making your best estimate of their possible effects.

PRESENTING YOUR PLANNING

Concentrate the presentation of your realization plan on the significant milestones and the important interdependencies. Three elements will normally suffice:

- ◆ A chart showing your schedule
- ◆ The important milestones
- ◆ The important interdependencies between the work packages.

The CityScape business plan shows how these forms of presentation can be used in practice.

Checklist for realization schedule

Does your business plan answer the following questions?

- As your company grows, what tasks will it need to perform, and how can they best be grouped into work packages?
- What are the most important milestones in the development of your enterprise, and by when must you reach them?
- Which tasks and milestones are directly interconnected? What is the critical path?

7. Risks

Every enterprise involves risk — and this is particularly true of new, high-growth enterprises. When you start up a company, you might want to share this risk with investors. A thorough and open consideration of the risk involved will both win the confidence of your investors, and increase your own. By including the risks in your business plan, you show potential investors that you have thought your business idea through. If you don't do this, potential investors must assume that your presentation of the business idea or the development of the business is over-optimistic. So be careful: on the basis of their own experience, they may judge your business plan more harshly than it deserves — or even reject it entirely. However open you are about the risks, though, they should not take up more space in your business plan than the opportunities. If your business idea contains more risks than opportunities, there must be something wrong with it!

In this chapter you will find out:

- ◆ How to identify risks
- ◆ How to use sensitivity analysis to assess and represent risks.

One of the greatest myths about entrepreneurs is that they are risk seekers. All sane people want to avoid risk.

William A. Sahlmann

IDENTIFYING THE RISKS

Every enterprise is exposed to risks. There are risks in the company itself, and risks can arise in the environment that the company operates in. Risks are not static: they must be continually reassessed, and recognized in good time. Entrepreneurs must stay on their toes.

In your business plan, you should also include the countermeasures you propose to take. For example, you can hedge against exchange rate variations, or conclude long-term contracts with important suppliers, or have alternative distribution concepts ready in case of need.

Examples of risk

In the company

- ❖ Key positions cannot be filled
- ❖ A key member of staff, such as the head of development, leaves
- ❖ The loss of the prototype delays development and the launch of the product.

In the environment

- ❖ You can only sell half as much as you expected
- ❖ A key supplier's factory burns down
- ❖ Shortly after the launch, a competitor brings out a cheaper alternative product
- ❖ You cannot patent the technology
- ❖ Your distribution partner ends your partnership agreement.

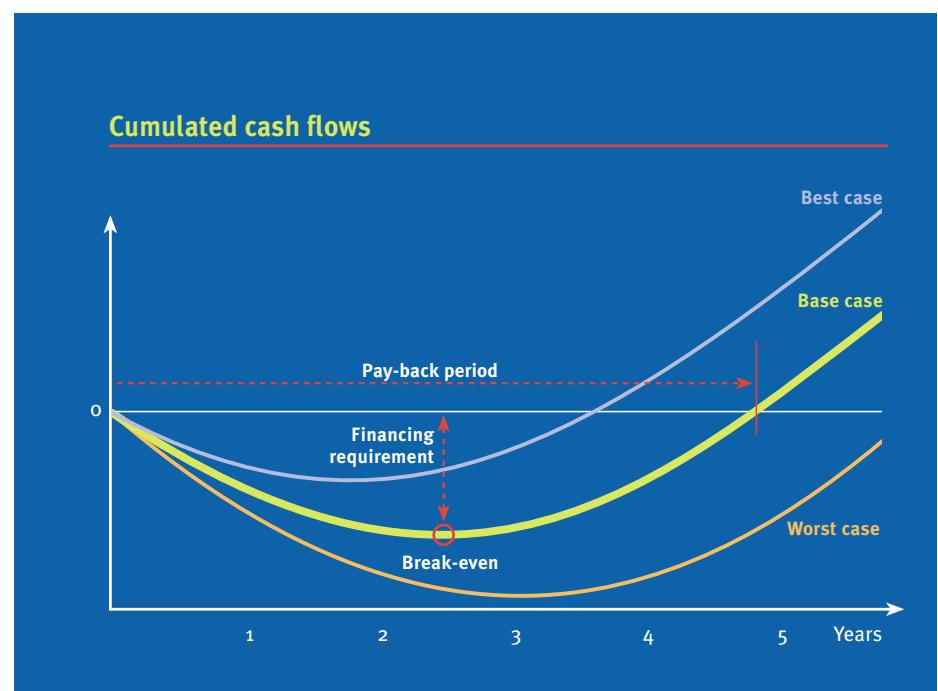
**Venture capitalists
can take a lot of
bad news, but they
hate surprises.**

*Jack Hayes
Entrepreneur*

SENSITIVITY ANALYSIS

Assessing risk is a matter of forecasting. Risks are never absolute, and can only be estimated on the basis of assumptions. These are generally displayed in the form of scenarios that enable the future development of the business to be simulated under various conditions. Your business plan should not contain more than three scenarios. The usual ones are:

- ◆ The “base case scenario”: what is, as far as you can tell, most likely to happen
- ◆ The “best case scenario”: what will happen if you can seize the opportunities you see, and your positive expectations are generally fulfilled
- ◆ The “worst case scenario”: what will happen if the risks do indeed occur, and your negative expectations are generally fulfilled.



These scenarios will give you insight into the possible development of the business and the funds that will be required. This insight will provide the management team and potential investors with a broader picture of the company's future. The "worst case scenario" also offers some more specific information on the stability of the business and the overall risks involved.

Give a short description of the scenarios in the business plan. What events, sales figures, prices, constants are they based on? You should provide a detailed description of the base case scenario; for the other two, a summary of the analysis in the form of the three most important key figures will be sufficient (the specialist terms are explained in Chapter 8, Financing):

- ◆ **Financing requirement:** How much capital is needed to finance the business?
- ◆ **Time to break-even:** When will there be a positive cash flow?
- ◆ **Internal Rate of return (IRR):** How much effective return will there be on the investment?

Risk checklist

Does your business plan answer the following questions?

- What risks can you see that might threaten the success of your enterprise?
- How will you deal with these risks, and how will you minimize their impact?
- What is the quantitative effect of the individual risks (scenarios)?
- How would the business survive the worst case?

8. Financing

The first question in financing is how much money it will take to launch and run the business successfully. To estimate the amount required, you can use a financial plan based on the assumptions you have used for the development of the business. The second question is how much cash you need to have available at any given moment for the company to be able to meet its current liabilities. This is a key financial planning task. The third question is how, and from where, you can obtain the funds you need. In the vast majority of cases the management team itself can only provide a fraction of the funds required. Finding investors thus becomes of existential importance for the company – "To be or not to be?" becomes a question of money.

In this chapter you will find out:

- ◆ Why liquid funds are crucial for every aspect of the business ("cash is king")
- ◆ What to include in your financial planning in the business plan
- ◆ How a company can be financed
- ◆ What to watch out for in the financing deal
- ◆ What you need to know about balance sheets, profit & loss statements, and cash flow calculations.

What kind of numbers do we like to see? The more mature a business is, the more we rely on numbers. For a newer business, the numbers matter less and the words matter more.

*Robert Mahoney
Investment banker*

CASH IS KING

Imagine that it is a cold winter's day and you have just ordered a hot dog from a stand on the street. There it is, steaming appetizingly, just the way you like it, with mustard and ketchup. You open your purse and are horrified to discover that it contains just 65 cents and 5,000 lire left over from your last holiday. Your credit cards are of little use here. Although financially sound, you are unable to pay for the product: you are insolvent.

The same thing can happen to your business if you do not plan properly. Your product may be fully developed, and your customers ready and waiting. Your business may be worth a good deal, in terms of future revenue; your books may show a profit, and your equity (the company's actual worth) may be increasing by the day. Nevertheless, the end of the month comes, there are wages, rent and bills to be paid, and there is exactly Dfl. 1,000 in the bank. True, you have sent out invoices for over Dfl. 50,000, but your generous payment terms mean that you cannot count on having enough money in the bank at the end of the month. In fact, you will not be able to meet your liabilities — you are successful beyond your wildest expectations, but nevertheless insolvent.

The common factor in both cases is that bills have to be paid in cash, and that a basically sound revenue situation is not of much help if you are insolvent. The hot dog case could have been solved easily enough with a trip to the nearest ATM. Your company, on the other hand, will need to find new sources of financing, and that will not be so easy to do at short notice. Careful liquidity planning would have enabled you to see the shortfall coming months in advance, thus giving you plenty of time to arrange a loan.

It is easy to forecast numbers with today's software. Show me the business model and your assumptions.

Brian Wood

When you start your company, you will be incurring costs before you generate income.

Money will be going out faster than it is coming in – you will have negative cash flow. The cash flow will remain negative until the point at which the incoming payments equal the money going out – the cash break-even point. The total negative cash flow till break-even must be financed in advance. So, if you expect that your company will have a cumulative negative cash flow of Dfl. 3.7 million, you need to ensure that financing of at least Dfl. 3.7 million (plus a bit extra to avoid liquidity problems) is available before you start up. Or, at the very least, you must know when and how you can get access to the money you will need.

FINANCIAL PLANNING IN THE BUSINESS PLAN

An enterprise should have access to the key figures regarding the business situation at any time. These numbers include profit or loss, the development of the cash flow, and the size of future capital requirements. You will find the basic financial information that you require in the section on "Basic accounting principles". If you have no prior business education or experience, we recommend that you read that section before you proceed.

The business plan should contain information on the company's future financial development, backed up with a rough financial plan. Detailed financial calculations are not necessary, as forecasts are by their nature approximate, and even more so for a new company. Professional investors are impressed by a small number of well thought through key numbers. Your business plan must answer the following questions:

- ◆ How much money does the company need over what period?
- ◆ When established, how much profit is the company likely to make?
- ◆ Which are the main assumptions underlying the forecasts?

This information will give investors an idea of how reasonable and plausible your numbers are. This will determine whether they will regard the project as attractive, and worth taking the risk of investing in it.

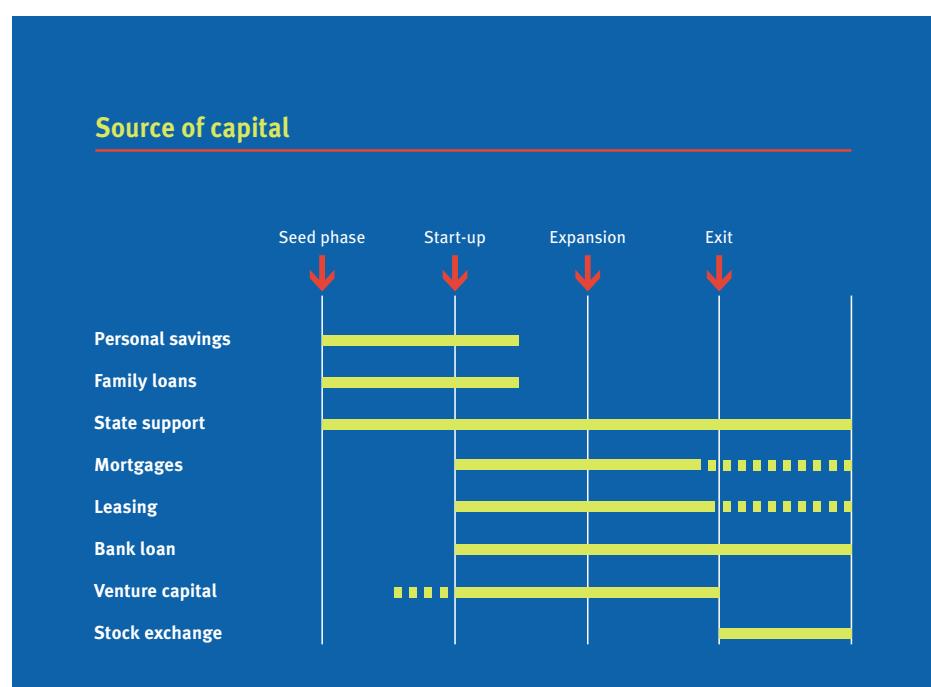
The minimum requirements for the financial planning in the business plan are:

- ◆ Cash flow calculation, profit & loss statement, balance sheet
- ◆ Forecasts for the next three to five years, and at least one year beyond break-even
- ◆ The first two years, shown quarterly or monthly, the rest annually
- ◆ All numbers based on thought through assumptions (only the most important ones need to be mentioned in the business plan).

SOURCES OF FINANCE FOR NEW BUSINESSES

Once you know how much capital you need for your business, the next question is where it is to come from. The capital is usually not needed all at once, but spread out over the various stages in the company's development. The diagram below shows what sort of capital is generally available at the different stages.

A company generally has access to a wide range of sources of capital. There is a basic distinction between equity (the owner's own funds) and loan capital. Providers of loan capital frequently require security for it in one form or another, such as a mortgage. Often, they also require particular accounting measures, so called covenants; otherwise the loan can be called.



The main sources of capital

Loan capital

- ◆ Family loans (loans from friends and relations, usually on very favorable terms)
- ◆ State support, e.g., research, job-creation or sector stimulation programs
- ◆ Mortgages
- ◆ Leasing
- ◆ Bank loans (a.o., “Tante Agaath” loan for new companies).

Equity

- ◆ Own savings
- ◆ Venture capital; professional companies or private investors
- ◆ Funds from established companies for research cooperations
- ◆ Stock exchange, via Initial Public Offering (IPO).

Family loans

- ◆ Suitable for: providing “seed money”
- ◆ Requirements: friends or relations prepared to risk own funds
- ◆ Advantages: simple, informal process, sometimes extremely favorable terms, direct personal relationship with the lender, tax-deductible interest payments
- ◆ Disadvantages: size of loan usually restricted, friends and relations exposed to risk, possibility of excessive interference by lender on account of personal relationship.

State support

- ◆ Suitable for: all start-up and development phases of the business
- ◆ Requirements: good knowledge of the possibilities, compliance with the conditions
- ◆ Advantages: generally very favorable terms (interest-free loans, long repayment periods or even grants)
- ◆ Disadvantages: process sometimes bureaucratic, long waiting periods, reporting requirements.

Mortgages

- ◆ Suitable for: financing business property and long-term investments in operating assets (machinery, etc.)
- ◆ Requirements: mortgageable property
- ◆ Advantages: easily determined and relatively favorable long-term conditions, no dilution of ownership of company, tax-deductible interest payments, low repayment rates over long periods
- ◆ Disadvantages: complete financing of mortgaged object rarely possible.

Leasing

- ◆ Suitable for: financing machinery, equipment, vehicles, etc.
- ◆ Requirements: leased object must be easily resellable — no specialized machinery
- ◆ Advantages: complete financing of object, no dilution of ownership of company, tax-deductible interest payments, some flexibility in return or exchange of object if requirements change (e.g., more powerful machine required)
- ◆ Disadvantages: limited to working life of object leased, higher interest rates than other means of financing, sometimes redemption payments at the end of the lease.

Bank loans

- ◆ Suitable for: short-term operating capital, from start-up to exit
- ◆ Requirements: secured against receivables (payments due from customers), inventory or equity
- ◆ Advantages: highly flexible, can be adjusted to current/seasonal needs, no dilution of ownership of company, tax-deductible interest payments. (The Dutch government has created the so-called “Tante Agaath” bank loan especially for starting companies, offering capital on favorable terms.)
- ◆ Disadvantages: security required, room to maneuver limited by minimum requirements for solvency of business (“Tante Agaath” loan is less strict).

Venture capital (professional)

- ◆ Suitable for: all stages from start-up to exit
- ◆ Requirements: sound business plan, business with high growth targets, investors must be able to exit completely via an IPO or a trade sale (sale of the company to a competitor, customer or supplier)
- ◆ Advantages: advice and active support of management team, assists in exit, no running costs (interest, loan repayments)
- ◆ Disadvantages: challenging and very time-consuming to obtain, larger dilution of ownership, risk of loss of control over business if targets are not met.

Private investor (business angel)

- ◆ Suitable for: seed phase and start-up phase in particular
- ◆ Requirements: depending on the investor, similar either to family loans or to venture capitalists
- ◆ Advantages: generally better conditions than venture capitalists
- ◆ Disadvantages: often have less time and energy for assisting management team in times of trouble.

THE DEAL

Money is never available for nothing. Your family may ask little in return, professional investors will ask more. All that the management team has to offer against the investors' cash are promises — not really a strong negotiating position. Nevertheless, you have every chance of doing very well financially if your business is successful, because professional investors are interested in seeing that the team achieves top performance. Just be clear about your own requirements and expectations, and those of your investors.

The management team's requirements

If you are looking for long-term commitment, and are satisfied with a small company, then you are probably well advised to make use of family funds, and loans from friends and banks. You will thus retain the majority shareholding, but you are restricting your opportunities for growth.

If, on the other hand, you want your business to grow quickly, you may need to work with venture capital. Venture capitalists usually expect to take a large share of the companies they invest in, although they may not want a majority shareholding. Professional investors are not, however, interested in running the company as long as it meets its targets, even if they have the majority of the shares. They have, after all, invested in the management team to lead the company to success. They will provide active support in managing the company and contribute their special expertise (e.g., operational, legal or marketing), relationships and contacts.

Think about these points:

- ◆ Should you insist on keeping the majority shareholding?
- ◆ Would having effective control over the company be sufficient?
- ◆ How much risk are you ready to bear? Would you be ready to share with more parties to reduce the level of risk?
- ◆ What are your financial expectations?

**Investors feel
a lot better
about the risk
if the venture's
endgame is
discussed upfront.**

William A. Sahlmann

The investor's requirements

All professional investors require a profit appropriate to the risk. There are, however, still considerable differences between investors, principally on the following points:

- ◆ Type and scope of risk deemed acceptable
- ◆ Size of investment
- ◆ Legal aspects, particularly tax breaks
- ◆ Period of time after which the return is required
- ◆ Extent of control required over the investment or the business, and mechanisms for exercising this control.

Many investors are prepared to wait a long time for their return, provided that when it comes, it will be high enough. Others are subject to time limits due to legal requirements, or the demands of their own lenders. This is the case, for example, with some investment funds that put some of their money into venture capital projects. If you intend to make use of several sources of capital, it makes sense to organize the future cash flows in order to meet the requirements of your investors as well as possible. For example, in a project involving property, it may be possible to use the substantial depreciation involved to win some tax breaks.

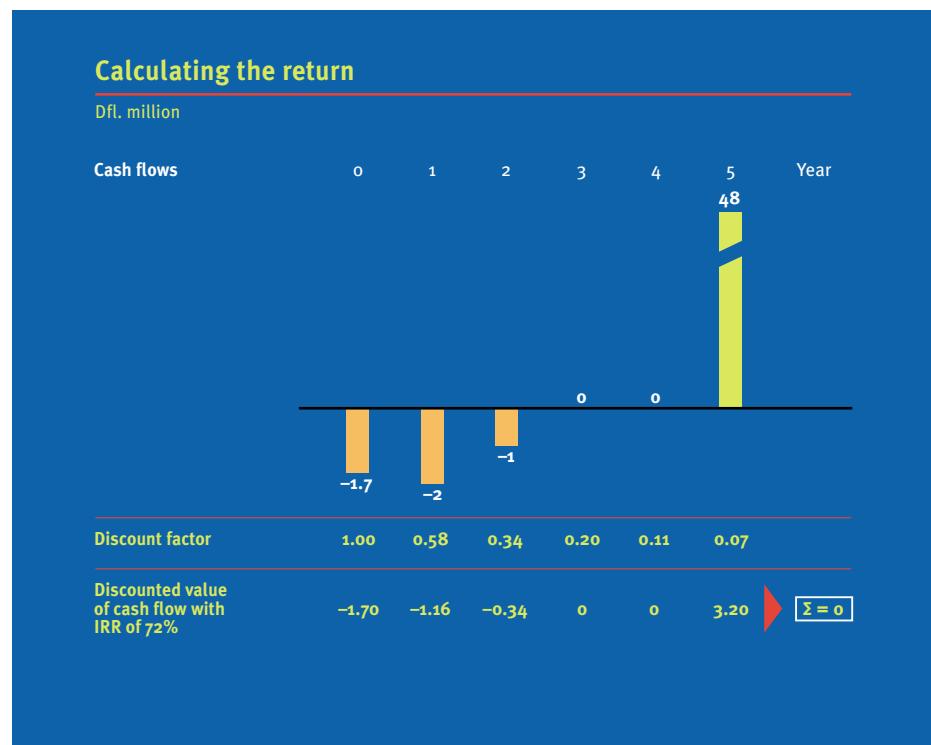
A deal can be very complicated. It is always advisable to get in touch with experienced entrepreneurs, and to get expert advice from accountants, tax consultants and lawyers.

Do not be put off by complicated arrangements — there are usually legitimate reasons for them, such as tax breaks, or control over the funds invested. But make absolutely certain that you understand all the details of the deal.

Calculating the investors' return

Investors assess the success of an investment in terms of the return they get on the capital invested. The expected return should therefore be visible at first glance in the business plan.

In the CityScape example, investors put a total of Dfl. 4.7 million into the enterprise over the first 3 years: 1.7 million in the first, 2 million in the second and 1 million in the third. When the company goes public after 5 years, it should realize a total of Dfl. 48 million. What is the return in this case?



From the investor's perspective, all funds put into a new company at first represent negative cash flow. After break-even, the company will not immediately pay out its positive cash flow in the form of dividends, but use it to strengthen the balance sheet. Cash will flow back to investors only upon the exit. As cash flows occur over several years, they need to be

discounted; that is to say calculated back to the present (compound interest effect). The discount factors for the individual years can be worked out using the following formula:

$$\text{Discount factor} = \frac{1}{(1 + r)^T},$$

where r = the discount rate in %, and T = the year in which the cash flow takes place. The basis for calculating the return is the Internal Rate of Return (IRR). The IRR is the discount rate at which the sum of all positive and negative cash flows, discounted to the present, is zero. The IRR for the CityScape project, for example, is 72% – that is, the investors get an annual return of 72% on their capital. This represents a high, but reasonable, return in view of the risks involved and the capital required to start the business.

Most pocket calculators and spreadsheet calculation programs have a special IRR function (e.g., in Excel the IRR() function). You can also do the calculation iteratively by hand.

Pricing a company – i.e., working out how much the market is prepared to pay for it when it goes public – is an art in itself. Prices are subject to investors' expectations of profitability and risks as well as market conditions, such as interest rates. A simple approach could be to analyze the price investors are willing to pay per unit of profit in a company with similar activities. This multiple of price to earnings can then be used to calculate the value. For most steady businesses, this multiple is at least 6. For CityScape, six times the net profit in year 5 (Dfl. 8 million) gives a value of Dfl. 48 million.

BASIC ACCOUNTING PRINCIPLES

Financial accounts have three parts: the profit & loss statement, the balance sheet and the cash flow calculation. The profit & loss statement shows the financial results over a period – usually one year. The balance sheet represents the financial situation of the company at a given date – frequently the end of the year. The most important calculation when planning and starting up an enterprise, however, is the cash flow calculation. It shows both entrepreneur and investors, what liquid funds were consumed or generated by a company over a given period.

The profit & loss statement

The profit & loss statement lists all the company's revenues and costs. It has a dual function: for one thing, it shows the result – a profit or a loss – of the company's business activities over a period of time. It also shows what components make up the company's result, and how they relate to one another. You can see, for example, what percentage of the total costs is accounted for by wage costs, or what proportion of total turnover is represented by material costs.

Comments on the items in the profit & loss statement

Revenue: income from products and services. This includes all income derived from the sale of products or services.

Cost of materials: all costs incurred through the use of materials are shown here. These include the raw materials used and the finished components purchased, as well as all the consumable materials used in production, such as adhesives, lubricants and maintenance materials.

Example of a simple profit & loss statement

| The Sample Co. N.V. | |
|-------------------------------------|------------|
| Revenue | 31.12.1996 |
| - Income from products and services | 1,350 |
| Costs | |
| - Cost of materials | 480 |
| - Personnel expenses | 390 |
| - Rent and leases | 20 |
| - Depreciation | 50 |
| - Maintenance costs | 2 |
| - Other costs | 3 |
| = Operating result | 405 |
| - Interest expenses | 70 |
| - Taxes | 115 |
| = Net income | 220 |

Personnel expenses: these include all the costs involved in employing people: the wages themselves, employer's state pension and disability insurance contributions, pension fund contributions, and also payments such as contributions to the staff canteen or to the running of a company's day care center.

Rent and leases: rental costs for buildings, equipment, vehicles, machinery, etc.

Depreciation: depreciation is not a cost in the sense that you spend money on it, but in the sense that it reflects the decrease in the value of the company's assets, which is booked as a cost. Depreciation has no effect on the cash situation, but it does compensate for the impact of investments on the profit or loss. For example, if a company buys a used vehicle for Dfl. 5,000, this investment represents a cash outflow.

The vehicle is used for five years and then has residual value of zero. So Dfl. 1,000 can be depreciated every year, and shown as a cost on the profit and loss statement.

Maintenance costs: the cost of maintenance and repair work required for the normal usage of buildings and equipment.

Other costs: income and expenditure that have no relation to the actual business activities of the company are booked here. This might include, for example, contributions to local associations.

Interest expenses: all interest due on loans, bank overdrafts, etc.

Taxes: Companies are taxed on their profit after interest payments. The total tax burden in the Netherlands is about 40%.

Net income / net loss: the profit or loss is the difference between revenue and costs over the accounting period. Profit or loss will be one of the most important yardsticks for measuring the success of an enterprise.

The size of the individual items in the profit & loss statement depends on what the business does. The table below shows the typical structure of the profit & loss statements in seven sectors. The examples used are established companies. New companies would need significantly higher net income (30%–50%) to have any chance of success.

Structure of the profit & loss statement in various sectors (%)

| | Textiles industry | Machinery | Supermarket chains | IT services | Electronics | Advertising agencies | Publishing |
|--------------------|-------------------|-----------|--------------------|-------------|-------------|----------------------|------------|
| Revenue | 100 | 100 | 100 | 100 | 100 | 100 | 100 |
| Costs | | | | | | | |
| Cost of materials | 50 | 46 | 78 | 26 | 60 | 52 | 8 |
| Personnel expenses | 21 | 26 | 10 | 40 | 17 | 16 | 26 |
| Third parties | 5 | 5 | 0 | 0 | 4 | 0 | 29 |
| Depreciation | 4 | 3 | 2 | 4 | 3 | 5 | 3 |
| Interest expenses | 2 | 1 | 1 | 0 | 1 | 1 | 1 |
| Other costs | 14 | 13 | 7 | 20 | 11 | 14 | 17 |
| Net income | 4 | 6 | 2 | 10 | 4 | 12 | 16 |

Source: Rabobank Cijfers & Trends

The balance sheet

The balance sheet presents the assets and liabilities of a company on a given day. It shows where a company's capital comes from and how it is invested.

Comments on the items in the balance sheet

Current assets: these include assets that are available at short notice, such as liquid assets (petty cash, bank and post office accounts, receivables [outstanding customer invoices]), stocks of finished goods, raw materials and components.

Fixed assets: fixed assets can generally not be disposed of at short notice. They include moveable equipment such as machinery, vehicles and computers as well as land and buildings.

Current debt: liabilities that must be met within one year are defined as short-term. Creditors are unpaid invoices from suppliers. Operating credits are short-term debt incurred in carrying out daily business, such as a current account overdraft.

Long-term debt: mortgages and bank loans are two examples of loan capital. There is a wide range of possibilities, and various financing possibilities are available, depending on the size of the business.

Equity: equity is the capital provided by the owner(s) of the business, plus the reserves and any retained earnings or accumulated losses. In the initial development phase, equity can be used to develop the business. Not infrequently, the equity is almost entirely consumed in the form of accumulated losses before the company's financial situation is such that it can be built up again in the form of retained earnings.

A basic principle of financing is that long-term assets should be financed with long-term capital, and short-term assets with short-term capital. This way you can ensure, for example, that there is no need to raise capital at short notice to refinance a long-term investment such as a piece of production machinery.

Example of a simple balance sheet

The Sample Co. N.V.

| Assets | 31.12.95 | 31.12.96 |
|--------------------------------------|------------|------------|
| Current assets | | |
| Liquid assets | 20 | 270 |
| Receivables | 30 | 35 |
| Inventory | 50 | 55 |
| Fixed assets | | |
| Equipment | 200 | 200 |
| Property | 150 | 170 |
| Balance sheet total | 450 | 730 |
| | | |
| Liabilities (capital) | | |
| Current debt | | |
| Creditors | 25 | 35 |
| Operating credits | 25 | 25 |
| Long-term debt | | |
| Loans | 200 | 200 |
| Mortgages | 100 | 120 |
| Equity | | |
| Share capital | 90 | 90 |
| Reserves | 5 | 5 |
| Retained earnings/accumulated losses | 5 | 255 |
| Balance sheet total | 450 | 730 |

Balance sheet structure in various sectors (%)

| | Foodstuff | Metal | Chemical products | Retail | Wholesale | Transport & Communication | Services |
|------------------------------------|-----------|-------|-------------------|--------|-----------|---------------------------|----------|
| Assets | | | | | | | |
| Current assets | 37.8 | 42.8 | 31.2 | 47.8 | 54.3 | 24.8 | 40.4 |
| Liquid assets | 5.8 | 7.8 | 3.1 | 10.9 | 8.3 | 6.7 | 11.6 |
| Receivables | 20.7 | 22.8 | 21.7 | 16.9 | 32.3 | 16.5 | 26.4 |
| Inventory and other current assets | 11.3 | 12.2 | 6.4 | 20.0 | 13.7 | 1.6 | 2.4 |
| Fixed assets | 62.2 | 57.2 | 68.8 | 52.2 | 45.7 | 75.2 | 59.6 |
| Financial | 35.8 | 35.3 | 35.4 | 20.0 | 33.3 | 9.5 | 29.0 |
| Property, plant & equipment | 26.4 | 21.9 | 33.4 | 32.2 | 12.4 | 65.7 | 30.6 |
| Liabilities | | | | | | | |
| Debt | 52.5 | 54.5 | 54.5 | 62.7 | 67.0 | 65.1 | 68.6 |
| Current debt | 27.6 | 31.1 | 27.0 | 33.2 | 42.1 | 21.5 | 39.0 |
| Long-term debt | 24.9 | 23.4 | 27.5 | 29.5 | 24.9 | 43.6 | 29.6 |
| Equity | 47.5 | 45.5 | 45.5 | 37.3 | 33.0 | 34.9 | 31.4 |

Source: Centraal Bureau voor de Statistiek

The asset structure depends on what business a company is in. A factory, for example, will have to invest a good deal more money in plant and equipment than a management consultancy.

The same is true of capital structure. A high proportion of equity is more customary in some sectors than in others. It is generally the case, though, that companies with a good proportion of equity find it easier to raise additional capital. The table shows the proportion of equity in seven different sectors. Note, however, that the figures all apply to established companies. Start-ups will find it virtually impossible to obtain unsecured bank loans, and will generally have a very high proportion of equity.

Cash flow from operating activities

The cash flow is the real measure of how much revenue a business is generating. It can be calculated directly, using the cash payments into and out of the company, or it can be derived from the balance sheet and the profit & loss statement.

The cash flow shows whether the operating activities are generating or consuming cash. There will be periods when the cash flow is negative, particularly when the enterprise is being built up. The total of these outflows of cash represents the financing requirement of the business.

Direct calculation of cash flow:

The table shows how to calculate the cash flow directly, using the movements of cash into and out of the business. The individual items in the calculation are explained in the section on the profit & loss statement. Note also:

Income from sales: what matters here is money actually received. Outstanding invoices do not count, even less confirmed orders; all that counts is invoices paid by customers.

Costs: here too, it is the actual money going out that counts. The time gap between production (cash costs) and the receipt of payment (cash income) produces the need for working capital, which must be financed. When a customer orders a machine, the company must first spend money on manufacturing it: on raw materials, for example, finished components, production time and transport costs. This cash outflow is only compensated by the arrival of payments: the intervening period must be covered by financing.

With a growing business, the net liquid assets will be rising continuously. Stocks will increase, more products will be delivered to customers before payment arrives, and so on. So, it is possible for a growing company to have a negative cash flow, which will require financing.

Direct calculation of cash flow

| | Month | 1 | 2 | 3 | 4 | 5 | 6 | 7 |
|----------------------------------|-------|-------------|---------------|---------------|---------------|---------------|---------------|---------------|
| Income from sales | | | | | | | | |
| Orders received/confirmed | | 100 | 150 | 80 | 210 | 130 | 120 | |
| Invoicing (= revenue = turnover) | | | 100 | 150 | 80 | 210 | | |
| Payment (= income) | | | | 100 | | | 100 | |
| Costs (= expenses) | | | | | | | | |
| Materials purchasing | | 10 | 30 | 50 | 40 | 140 | 60 | 70 |
| Personnel incl. social security | | 50 | 50 | 50 | 50 | 50 | 50 | 50 |
| Publicity | | 20 | 20 | 50 | 40 | 30 | 20 | 20 |
| Rents | | 10 | 10 | 10 | 10 | 10 | 10 | 10 |
| Other | | 10 | 10 | 10 | 10 | 10 | 10 | 10 |
| Tax | | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Interest | | 2 | 2 | 2 | 2 | 2 | 2 | 2 |
| Total costs | | 102 | 122 | 172 | 152 | 242 | 152 | 162 |
| Cash flow | | -102 | -122 | -172 | -152 | -242 | -152 | -62 |
| Investments (= expenses) | | | | | | | | |
| Plant and equipment | | 500 | 500 | 300 | 140 | | | |
| Liquidity | | | | | | | | |
| Cash outflow (-), inflow (+) | | -602 | -622 | -472 | -292 | -242 | -152 | -62 |
| Cumulated liquidity | | -602 | -1,224 | -1,696 | -1,988 | -2,230 | -2,382 | -2,444 |

As well as the operational cash flow, money is needed for investment in future activities. These investments have an immediate effect on the cash situation (unless they are made via leasing or credits from suppliers). The income they will generate only becomes available at a later date, however, so they too need to be financed.

When a business is generating sufficient operational cash flow to finance its investments, it has become “self-financing”. Established companies are generally self-financing; start-up companies, on the other hand, must generally finance their growth with external funds (loan capital or equity).

Calculating the cash flow from the profit & loss statement and the balance sheet

The table shows how to calculate the cash flow indirectly, using the profit & loss statement and the balance sheet.

To calculate the cash flow indirectly, you start with the operating result in the profit & loss statement. The first step is to add all expenses that have no effect on the cash situation, e.g., depreciation. The second step is to take account of all changes in the balance sheet that do affect the cash situation. If, for example, inventory levels have risen, this additional value must be paid for in cash. An increase in the number of creditors, on the other hand, produces an added flow of cash, as goods and services have been obtained, but their suppliers have not yet been paid.

Indirect calculation of cash flow

The Sample Co. N.V.

| | |
|---|------------|
| Operating result (profit & loss statement) | 405 |
| + Depreciation (profit & loss statement) | +50 |
| - Increased value of stock (balance sheet) | -5 |
| + Increased value of creditors (balance sheet) | +10 |
| - Increased value of receivables (balance sheet) | -5 |
| + Sale of property and equipment (balance sheet) | 0 |
| - Investments in property and equipment (balance sheet) | -20 |
| Operational cash flow | 435 |
| - Interest (profit & loss statement) | -70 |
| - Taxes (profit & loss statement) | -115 |
| Net cash flow | 250 |

Financing checklist

Does your business plan answer the following questions?

- What assumptions is your business plan based on?
- How large is the company's capital requirement until break-even?
How much cash will be needed in the worst case?
- Where will that capital come from?
- What does the deal look like for potential investors?
- What return can investors expect?
- How will they realize their profits?

CityScape business plan

It's a funny thing
about life;
if you refuse to
accept anything
but the best,
you very often
get it.

Somerset Maugham

Comments on CityScape

The original version of the CityScape business plan was prepared in 1994, for the American market. For this manual, it has been updated and adapted to Dutch circumstances.

CityScape was not actually started by its “inventors” at the time. Since then, however, several companies, both start-ups and established businesses, have launched similar concepts.

CityScape

Business Plan

Start-ups

| <i>Service</i> | <i>URL</i> |
|------------------|---------------------|
| CitySearch | www.citysearch.com |
| CityView | www.cityview.com |
| Excite Travel | city.net |
| Lycos City Guide | cityguide.lycos.com |
| Yahoo! Metros | www.yahoo.com |

17 November 1997

Established enterprises

| <i>Service</i> | <i>URL</i> | <i>Operator</i> |
|----------------------|---------------------|-----------------|
| City Sites | www.cimedia.com | Cox Enterprises |
| Digital City | www.digitalcity.com | America Online |
| Pacific Bell At Hand | www.athand.com | Pacific Bell |
| Sidewalk | www.sidewalk.com | Microsoft |

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Appendix

1. Executive summary

Entrepreneurial function of CityScape

CityScape develops and markets easy-to-use interactive software for the World Wide Web, which:

1. Presents consumer information on local businesses, events, cinemas, restaurants, weather forecasts, etc., in a user-friendly fashion
2. Acts as a carrier for advertising by local businesses.

Background: explosive growth of Internet market

Internet and the World Wide Web have become a platform for an electronic marketplace. The number of Internet users is growing rapidly, and many companies are considering how they can best take advantage of this new channel. Its interactivity and multimedia potential make the Web an ideal publicity and sales tool. Information can be updated quickly and easily, and disseminated cost-effectively, and companies can also gather information on customer preferences. Current forecasts suggest that the value of the electronic marketplace will rise from today's Dfl. 40 billion to Dfl. 150 billion by 2000.

Problem: local information difficult to locate

The number of home pages on the World Wide Web and the available information are growing explosively. However, locating specific information, and particularly local information, is very difficult and time-consuming; this problem will get worse. Access to the Internet, and thus to their local customers is also not so easy for small businesses. CityScape offers a solution to these problems.

Product: bundling and appropriate presentation of local information

CityScape is at the same time an interactive WWW index and a commercial platform for small and medium-sized businesses. CityScape organizes, in a user-friendly way, everyday information about local events, restaurants, addresses, film tips, and commercial information about (local) businesses and what they have to offer. It provides local businesses with a channel for publicity and sales. This service goes from listing contact addresses (similar to the Yellow Pages) to setting up complete interactive sales catalogs, with electronic processing of transactions.

The company and its management: an experienced, highly motivated team

The management team is made up of four people with excellent qualifications and extensive experience. All are fully committed to the project, and determined to make a success of CityScape. The team has excellent knowledge and experience in marketing and sales and comprehensive financial and technological expertise.

Business system: concentration on our strengths

Consumers can use CityScape at no cost. Using it in sufficient numbers, they will create an incentive for businesses to pay a charge in order to be present in CityScape. The charges will consist of a one-time installation fee and monthly subscription fee. CityScape specializes in marketing and sales to consumers and local businesses and the integration of existing Internet technologies (search engines, transaction processing etc.). Internet access and the maintenance of the computer infrastructure will be outsourced to local Internet providers. CityScape will first be introduced in towns and regions with a high level of WWW penetration; our aim is to establish CityScape as the de-facto standard for local information management and the processing of local and regional business transactions.

Financing: 68% IRR for first-round investors

The growth forecast suggests that CityScape will achieve sales of some Dfl. 68 million in year 5, with a net profit after tax of 12% of sales. By then, CityScape will be present in about 100 towns, and employ a staff of about 90. The founders will provide start-up equity of Dfl. 200,000. CityScape is looking for investors who know the sector well, and who can actively support the team in building the business. In the first financing round, CityScape offers a holding of 60% for Dfl. 1.5 million. A further Dfl. 2.0 million will be required 12 months later, and Dfl. 1.0 million 12–15 months after that. An IPO seems possible after 5 years of operation. Based on our valuation of the business in year 5, the IRR for first-round investors would be 68%.

2. Product idea

2.1. Current situation – Internet trends and market forces

Over the past years, the Internet/World Wide Web (WWW) has developed into the backbone of the much-discussed "Information Superhighway". Its use is no longer restricted to government and academic circles, and it has become a tool with potential benefits for millions of consumers. According to the most recent estimates, there are some 60 million Internet users worldwide; with an annual growth rate of 30–40% there will be almost 200 million by the end of the year 2000. With usage on this scale, businesses of all sizes have discovered the Internet. There are already more commercial users than private ones, and their number is increasing more rapidly. "Virtual shop-windows" and "electronic shopping centers" are an integral part of the WWW. Electronic shopping sales are already at Dfl. 10 billion per year, and electronic retail trading is expected to reach Dfl. 100 billion by 2000. The Internet is particularly interesting for small businesses, as it enables them to operate in the same competitive environment as large companies.

Information management and WWW commerce

The great benefit of the WWW lies not in its infrastructure, but in the overwhelming quantity of information it makes available to all its users. However, the decentral organization and presentation of the information makes finding specific information a complicated and time-consuming process. Many users enjoy "surfing" on the Internet, but they find searching for specific information highly frustrating. Finding out whether a film is on at the cinema, or booking a table at a restaurant, for example, can still be done more quickly by telephone. And small businesses wishing to address Internet users in their area find it difficult to make consumers aware of their presence on the Internet and to encourage them to visit their web site. Whether or not the Internet becomes a valuable commercial distribution channel in the future depends mainly on whether, and by whom, new forms of information presentation can be developed.

Thus, the realization of the "Information Superhighway" stands or falls with the management of information directed to the entertainment, communication and information needs of the average citizen. **CityScape offers a solution for this problem.**

2.2. CityScape – the product

CityScape is a WWW software package that offers at the same time an interactive WWW index and a commercial WWW platform for small and medium-sized businesses (Exhibit 1 and 2). The value of CityScape lies in the presentation and distribution of information from local businesses in a form which is quicker and easier for consumers to access than previous information offers.

- CityScape organizes the local information available to consumers in a town or region, such as local news, calendars of events, weather forecasts, restaurant and cinema information, address books and telephone directories, complete lists of businesses and organizations. The index includes simple town plans and an easy to use search engine.
- CityScape offers local businesses a sales and publicity channel. Possibilities range from listing a company's address to complete interactive sales catalogs with electronic transaction processing. CityScape will assist small businesses in producing simple, economical Internet pages, offering three options:
 - *Basic service* – comprises one page of text and graphics: for example, a brief description of the company, with telephone number, address, details of how to get there, etc.
 - *Deluxe service* – comprises up to 10 pages of text and graphics and advice on the best layout or setup of the web site; monthly reports to the company's management provide information about the number of visitors to the web site and their demographic profile.
 - *Catalog service* – complete catalog with transaction processing. This comprehensive service enables companies to do business over the Internet. The service includes detailed advice, regular reports to the company's management and frequent updating of the site.

3. Management team

The management combines the individual strengths of the four founders into a committed management team with a shared vision.

John, General Manager and Head of Finance

John worked in marketing at Procter and Gamble for 8 years, and successfully managed a sales region with annual sales of Dfl. 12.5 million. He was awarded an MBA at IMD in Lausanne at the end of 1997; he also has a degree in Chemical Engineering from the TUD Delft.

Ann, Sales Manager

Ann has a degree in Business Economics from the EUR Rotterdam, and has also studied electrotechnology at the TUE Eindhoven. She gained practical experience in sales to an international clientele as assistant to the Sales Manager of a medium-sized mechanical engineering company.

Bill, Development Manager

Bill is an Assistant at the "Centrum Wiskunde en Informatica" (UvA) Amsterdam, where he will be completing his Ph.D. thesis in March 1998. His areas of research are communication systems and computer networks. He worked for Alcatel for 18 months as a C++ programmer and software assembler. Bill is a freelance software developer.

George, Marketing Manager

George has a degree in electrical engineering from the UT Enschede and is currently studying business economics at the UvA Amsterdam. He has worked for IBM as a hardware designer for optical data communication and carried out market research for a strategy consultancy.

Positions to be filled

An Internet specialist familiar with WWW technologies (search engines, design of home pages) will be required to complete the range of skills required by CityScape. A person familiar with electronic trading is also sought, for the processing of business via CityScape.

4. Marketing plan

4.1. Market size

Potential customers of CityScape are small and medium-sized companies that currently market their products and services via conventional channels such as the Yellow pages, print media and radio. Geographically, CityScape will initially be launched in the Netherlands and neighboring countries. In this area there are over 5 million businesses with fewer than 250 employees (Exhibit 3). All sectors (trade, construction, other service providers) are potential customers, with the exception of the industrial sector. On the assumption that 60% can be reached, there are some 2.8 million potential customers. Our target is to have 50,000 customers within 5 years; this represents a market penetration of 2% of the total potential.

4.2. Customer needs

Retail traders want a cost-efficient distribution channel which enables them to reach as many consumers as possible. The products and services must be offered in an attractive fashion, the channel must be easily accessible and easy to use, regularly updated, and enable interactive communication.

To get a better understanding of what businesses need from a distribution channel, we have talked to potential customers. Most potential customers appeared very interested in an Internet presence at the prices we are proposing. The discussions showed that the following requirements are most important for customers – our product meets them all.

- *Attractive publicity:* interactive advertising at comparatively low prices
- *Business transactions:* the possibility of performing a complete transaction, from advertising, through order processing, to receipt of payment
- *Information feedback:* rapid and reliable feedback of data on consumer behavior and purchasing patterns
- *Marketing support:* support for marketing products and services – most small companies are fully occupied with day-to-day business
- *Sales enhancement:* ultimately, a sales channel will only be used if it has a positive effect on the company's revenue situation.

CityScape addresses all these customer needs. We are therefore convinced that this represents an attractive offer for our target customer segment.

4.3. Competitor analysis

CityScape will be in competition with the following suppliers:

- *Yellow Pages:* this is the primary source for local and regional information on small businesses. All companies listed in the Yellow Pages pay a fee dependent on the size of the entry. Yellow Pages providers are not at the moment in a position to exploit the advantages of the Web, as they are based on a different business model, i.e., data are only irregularly updated and there is no customer advice or service component.
- *Print media:* newspapers and magazines may lose a part of their advertising revenue to the WWW: the first online newspapers are already on the market. However, it seems unlikely that publishers will see themselves in a new role, and shift from being information suppliers to information organizers.
- *Telecom and cable companies:* the telecom companies are the owners of the physical network by which the Internet reaches its users; it also offers "value-added" services, such as "Het Net". CityScape's advantage over its competitors comes from its regional orientation and its particular attractiveness for "corner shop" businesses.
- *Own networks:* access providers like CompuServe, Planet Internet and Microsoft Network offer their own services for a monthly fee, which represents the major part of their income. However, we are convinced that these services will not establish themselves, as private customers will not be prepared to pay for them.
- *Internet presence providers, search engines and indexes:* Internet presence providers are CityScape's most direct competitors in terms of indexes, "shop window" space, text services and transaction processing. There are hundreds of such companies: we have talked to over 130 of them, or visited their homepage. Our conclusion is that most presence providers are still at a very early stage of development, and are proceeding very much at random. In general they only have a handful of customers in Europe, and attracting customers is likely to be their greatest problem. CityScape, accordingly, intends to develop core skills here, and use these strengths in marketing and sales to build up partnerships with presence providers (see Business system chapter).

4.4. Marketing strategy

Within three to five years, we see CityScape as the established Web index for local users throughout the Netherlands and neighboring areas. CityScape will therefore make every effort to get new towns into the network as quickly as possible. To ensure continuous growth, we have adopted a franchise-type business model, and are concentrating our activities on marketing and sales.

Promotion and distribution of services – trade and consumer advertising

CityScape addresses both the trade and consumers. If a large number of consumers are interested, this will be an incentive for businesses to be present on CityScape; we too want to get as many businesses on CityScape as possible.

- *Trade:* customer acquisition will begin with a direct mail campaign to all businesses in the area. Then, important sectors and other customers who have expressed interest will be addressed with a telephone campaign. Representatives will call on potential customers personally. The number of representatives will be increased in proportion to the number of new customers acquired.
- *Consumers:* consumers will be addressed via local advertising channels – print media, local TV, radio. By concentrating on one area or town at a time, we can reduce advertising expenditure, while still deriving synergies from neighboring communities already served by CityScape.

Advertising expenditure

Our budget for trade and consumer advertising is Dfl. 100,000 per town and year. In the first year CityScape is introduced in a new town, we allow an additional Dfl. 100,000 for the development of the CityScape brand identity, making a total of Dfl. 200,000 per town. This calculation assumes a town with 2,000 businesses, of which 500 should become customers. As the CityScape introduction process will be the same in every town, we expect some savings on the cost of developing advertising campaigns. CityScape will make every effort to continuously improve its advertising program, to maximize the impact per guilder spent.

Pricing

Customers pay a one-time installation fee for setting up their page, and a monthly fee as long as they make use of CityScape's services.

Products, prices and market segments, in Dfl.

| | Description | Installation fee | Monthly fee | Proportion of customers |
|------------|--|------------------|---------------|-------------------------|
| Product 1: | Basic option. WWW homepage with 1 page of text and graphics | 100 | 50 | 70% |
| Product 2: | Deluxe option. WWW homepage with up to 10 pages of text and graphics, installation advice | 400 | 200 | 25% |
| Product 3: | Catalog service. Complete catalog with transaction processing, installation advice | 2000 | 500 | 5% |
| Product 4: | Homepage update | | 25 per update | |

The prices are based on customer surveys and comparisons with competitive products currently available. They also allow for possible reductions in fee levels when the services are further spread, and the number of competitors increases.

Customer service

Our aim is a high level of customer and consumer loyalty to our services. We will therefore make every effort to put the customer at the center of our operations, and to root this attitude firmly in our corporate culture. Our 0800 customer service number will be served by specially-trained, customer-friendly staff.

4.5. CityScape's competitive advantages

CityScape has several sustainable competitive advantages:

- *"First Mover" advantage:* when the majority of businesses in a town are present on CityScape, it will be difficult for a competitor to entice individual businesses away.
- *Economies of scale in advertising:* it will be difficult for competitors to match the cost-efficiency of our advertising campaigns – unless they are able to spread their costs over a large number of customers. As the number of towns in which we are present increases, we will be able to develop and test several advertising campaigns simultaneously and use these insights to continually enhance our advertising impact.
- *Brand name:* for the consumer, our brand name will represent an information medium that provides people with up-to-date, comprehensive information on all they need to know about their town and its businesses. For businesses, our brand will represent a service that, for a reasonable price, makes local consumers aware of their websites, and ensures that they can use them for their transactions.

- *Economies of scale in technological development:* consumers will only be attracted to websites by leading-edge technology and the "hottest" website features. CityScape will engage the best specialists in this area. We shall also be able to apply experience from individual towns to the whole CityScape network.
- *Marketing and sales orientation:* at the moment most Internet presence providers are "one-stop shops", offering all the services required for a presence on the Internet. CityScape, on the other hand, will concentrate on marketing and sales and continually improve its service to local businesses.

5. Business system and organization

The business system

CityScape will concentrate on the development of excellent skills in marketing and sales (to consumers and small businesses) and on the integration of existing Internet technologies (search engines, encryption technologies, etc.). Most of the installation work and the maintenance of CityScape homepages will be outsourced to so-called Internet presence providers. CityScape will equip the Internet presence providers with CityScape software; the providers will independently offer their Internet services, such as the installation and maintenance of homepages, as contractual partners. CityScape will carry out the invoicing of all customers, and recompense the presence providers for their services.

Partnerships with presence providers

There are already several dozen providers on the market, offering homepage design and installation services; we shall enter partnerships with some of them. To succeed, partnerships must offer benefits to all those involved. We see the following benefits from a partnership:

Acquiring customers: we have seen that most local presence providers are too small or too inexperienced to address potential customers with direct marketing campaigns. We shall therefore set up our own direct sales and marketing team, in order to gain a continuous flow of new customers. This will also enable the presence providers to concentrate on their technical skills.

Enabling a wide range of services: most presence providers only offer a limited selection of the broad range of customer-specific solutions envisaged by CityScape. CityScape will also offer the software tools necessary to integrate new services of all sorts.

The main advantage of partnerships for CityScape is that we can exploit the strengths of the presence providers, and thus grow much faster than we could on our own.

The main problem with partnerships is finding an equitable way of sharing the income. Our research has enabled us to identify a sharing system that is attractive for presence providers. Presence providers receive 75% of the installation fee plus between 25% and 50% of the monthly fees. We have discussed this with local presence providers in particular, and also analyzed prices for Internet-related services.

Organizational structure and management style

The management team consists of the four founding members, who fulfill the functions of CEO, head of finance, head of development, and head of marketing. As mentioned in the

Section "Management team", we are looking for further members to strengthen our team, which might result in a shift of the current responsibilities.

CityScape's management will adopt a cooperative style of management, and intends to work as a team. Remuneration will be strictly performance-related; all members of the team will have a share in the financial development of the company. A significant part of the start-up capital is reserved for the creation of such an incentive system.

Operating location(s)

CityScape will begin operations in Amsterdam, and this is where the head office will be. Proximity to the "Centrum Wiskunde en Informatica" and the presence of a number of technology companies in the Amsterdam area offers excellent opportunities to find talented staff and to get in contact with new technologies.

Personnel planning

Our personnel forecast for the first five years of operation is set out in the following table. Most staff will be employed in sales, marketing and customer services. The number of staff will be proportional to the number of new customers. The development and maintenance of innovative software will also require an experienced development department.

Personnel by function

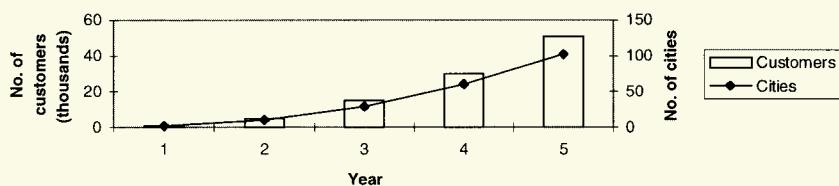
| | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 |
|----------------|--------|--------|--------|--------|--------|
| Development | 5 | 6 | 11 | 21 | 31 |
| Sales & Mktg. | 8 | 12 | 24 | 34 | 50 |
| Administration | 3 | 5 | 7 | 10 | 10 |
| Total person. | 16 | 23 | 42 | 65 | 91 |

6. Realization schedule

Growth strategy

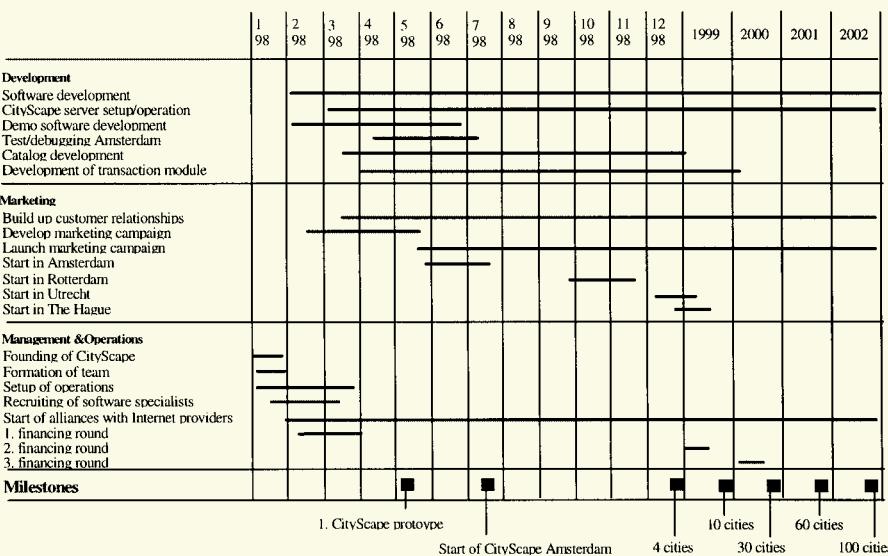
We will achieve growth by establishing CityScape in new towns and regions in the Netherlands and neighboring countries. With its very large number of Internet connections, Amsterdam will serve as a pilot city. It will be followed by the other large towns in the Netherlands: Rotterdam, Utrecht, The Hague and Eindhoven, and towns in Germany and Belgium.

Projected growth of CityScape



Development plan

In the first six months of business, we shall focus on the following: building up the management and software development teams, developing a prototype for the CityScape product, market analysis, contacts with potential customers and acquiring capital.



7. Risks

The success of CityScape will depend on several factors; the most important are:

Demand side: will consumers use the Internet for local and regional information?

This will depend on whether the Internet achieves recognition as the medium that offers users more information more quickly and more easily than any other medium. During the development stage we will use consumer market research to find out how we need to present ourselves in order to convince our target customers (businesses) of the specific benefits of CityScape. As the pilot city, Amsterdam will also serve to check the validity of the CityScape idea. Should the results be negative, only limited damage would be done, and we could take remedial measures before continuing.

Supply side: will businesses be enthusiastic about this marketing channel?

Acceptance by businesses will depend on whether they experience actual benefits. Initially, our publicity will emphasize CityScape's interesting advertising possibilities, marketing support, the direct processing of transactions and information about customer preferences. We believe that, with these arguments, we will be able to motivate many businesses to test CityScape. They will only become long-term customers, however, if we can clearly show that both the transmission of advertising messages and the processing of transactions is significantly better than via conventional channels.

Competition: will large-scale providers such as Microsoft or Telecom enter the market?

It is possible that major suppliers will enter the market for "Information Packaging". Software and telecommunications companies see great opportunities here. We believe that with our concentration on local information and small businesses, we will be able to create a competitive advantage that will also prove effective against large providers.

In addition to these qualitative aspects, we have also used sensitivity analysis to give a quantitative estimate of the risks. This analysis is integrated in the finance plan.

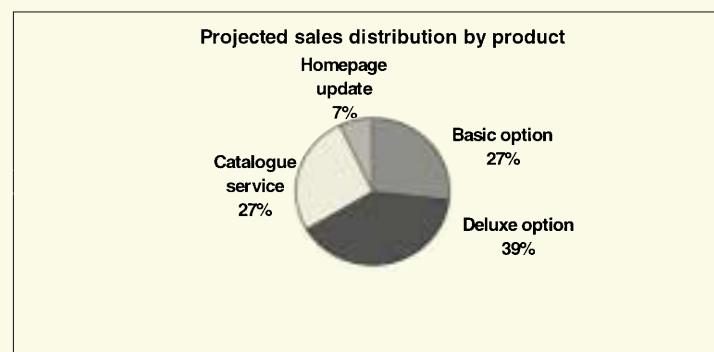
8. Financing

8.1. Finance plan

We expect that CityScape will have 50,000 customers and sales of Dfl. 67.8 million within 5 years; we estimate a net profit after tax of Dfl. 7.9 million.

Sales forecast

Our sales forecast is based on the expected distribution of customers between the various options. According to our estimates, 70% of customers will choose the basic option, and 25% the deluxe option (e.g., restaurants); only 5% of customers are expected to be interested in the catalog service – the most expensive and comprehensive option. We expect only customers with the deluxe option and catalog service to require regular updating of their homepages.



Forecast sales growth

The sales growth forecast is based on the assumption that by the end of year 5 we will have reached 20% of our target customers (total 50,000 customers). On account of the fixed number of businesses, we expect that growth will be less rapid in the following years. The growth scenario is based on an average town with 2,000 businesses, 50,000 inhabitants, and 500 paying customers.

Summary of financials

The expected financial results are shown in the form of the expected cash requirement (Exhibit 4), cash flow calculation (Exhibit 5), expected sales and net profit (Exhibit 6), profit and loss statement for the first 5 years (Exhibit 7) and balance sheet (Exhibit 8). The key assumptions on which the finance plan is based are also shown. (Exhibit 9).

Cash flow and sensitivity analysis (Exhibits 4 and 5)

Exhibit 4 shows CityScape's total cash requirement for the first 5 years on the basis of 3 different scenarios. The three key levers of the financial calculations are the forecast growth rate, total income from customers, and the percentage passed on to our partners (Internet presence providers). As Exhibit 4 shows, these indicators demonstrate a high level of sensitivity.

- The assumptions for the base-case scenario correspond to the Exhibits given; on this basis there is a financing requirement of Dfl. 4.5 million. Payback is expected in mid-2001. First-round investors can expect an IRR of 68%.
- The best-case scenario assumes an annual growth rate of 10%, 10% more income from our customers, and 10% less income to be shared with our partners. With this scenario, the financing requirement is Dfl. 3.2 million. Payback will be achieved about nine months earlier. The IRR for first-round investors is 96%.
- The worst case scenario assumes 10% less growth, 10% less income and 10% more income to be shared with our partners. The financing requirement is Dfl. 6.5 million, with payback expected by 2004. With this scenario, IRR for first-round investors is 44%.

Income, profit and balance sheet (Exhibits 6, 7 and 8)

Sales in year 5 are forecast to reach Dfl. 67.8 million. Net profit before tax will be positive from the start of the fourth year of operations, and will rise to 12% or Dfl. 7.9 million in year 5.

Gross margins will be around 55% for the first five years; this reflects the payments to presence providers for recording and maintaining our customers' homepages. As a rule, the presence providers will receive the main part of the one-time installation fee, while CityScape will receive the main part of the continuing monthly fees. We also estimate a monthly expenditure of Dfl. 10,000 per town to cover additional local information on current events, weather forecasts, restaurants, cinemas, etc. Operating costs will be incurred primarily in marketing, sales, and advertising campaigns. Initially, software development and the start-up of operations will also incur significant costs.

The balance sheet reflects CityScape's revenue mechanism, based on fee income and variable costs. Capital investments are minimal, as no manufacturing plant is required and offices can be rented. Computer hardware and software for application development represents a significant investment. The base-case scenario does not envisage any need for third-party capital.

8.2. Financing

The initial financing of Dfl. 200,000 will be provided by the founders' private means. This sum will be required for the initial development phase, in which application software will be developed and tested and investors sought. We expect to obtain Dfl. 1.5 million by March 1998, in exchange for 60% of the shares in the company. These funds will enable us to develop the software applications to ready-to-use status, employ sales staff and begin marketing activities. This first financing round will last about one year. We are looking primarily for a venture capital company with profound knowledge of the sector, which can assist us to attract experienced software developers and sales staff. A significant part of the start-up capital is reserved for an incentive system for the members of the management team.

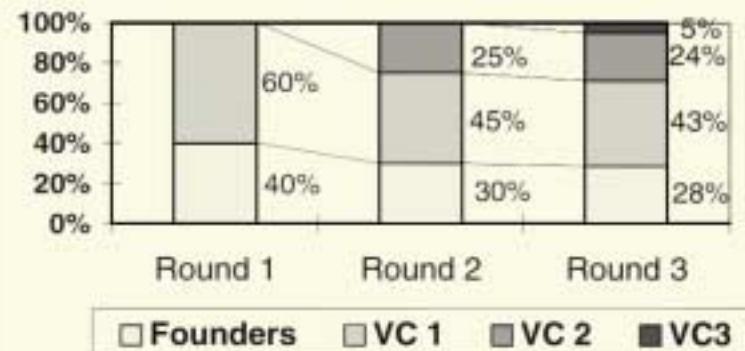
The second financing round is envisaged for the start of 1999; we then want to raise an additional Dfl. 2 million, which will be used for further growth in exchange for 25% of the share capital.

To finance more growth, another Dfl. 1 million will be required in a third financing round in 2000. Our scenario envisages the sale of 5% of the equity. After this round, CityScape will be able to finance itself until it goes public, as intended, at the end of the fifth year of operation.

CityScape financing rounds

| | Date | Amount (Dfl.) | Price per share | Source |
|--------------|---------------|---------------|-----------------|-----------------|
| Own reserves | January 1998 | 200,000 | 0.01 | Founders |
| Round 1 | March 1998 | 1,500,000 | 0.05 | Venture capital |
| Round 2 | Start of 1999 | 2,000,000 | 0.12 | Venture capital |
| Round 3 | 2000 | 1,000,000 | 0.29 | Venture capital |

The Exhibit below shows the shareholdings after each financing round.



Realization strategy

With assumptions specified and resulting growth rates, an initial public offering could be considered by the end of the fifth year of operation. Assuming a conservatively estimated price/earnings ratio of 6, this would give a market capitalization in year 5 of Dfl. 47.6 million. With the financing structure set out above, the first-round investors (VC 1) would achieve an IRR of 68%, second-round investors (VC 2) an IRR of 54%, and third-round investors (VC 3) an IRR of 34% in the base case scenario.

Valuation of CityScape in year 5

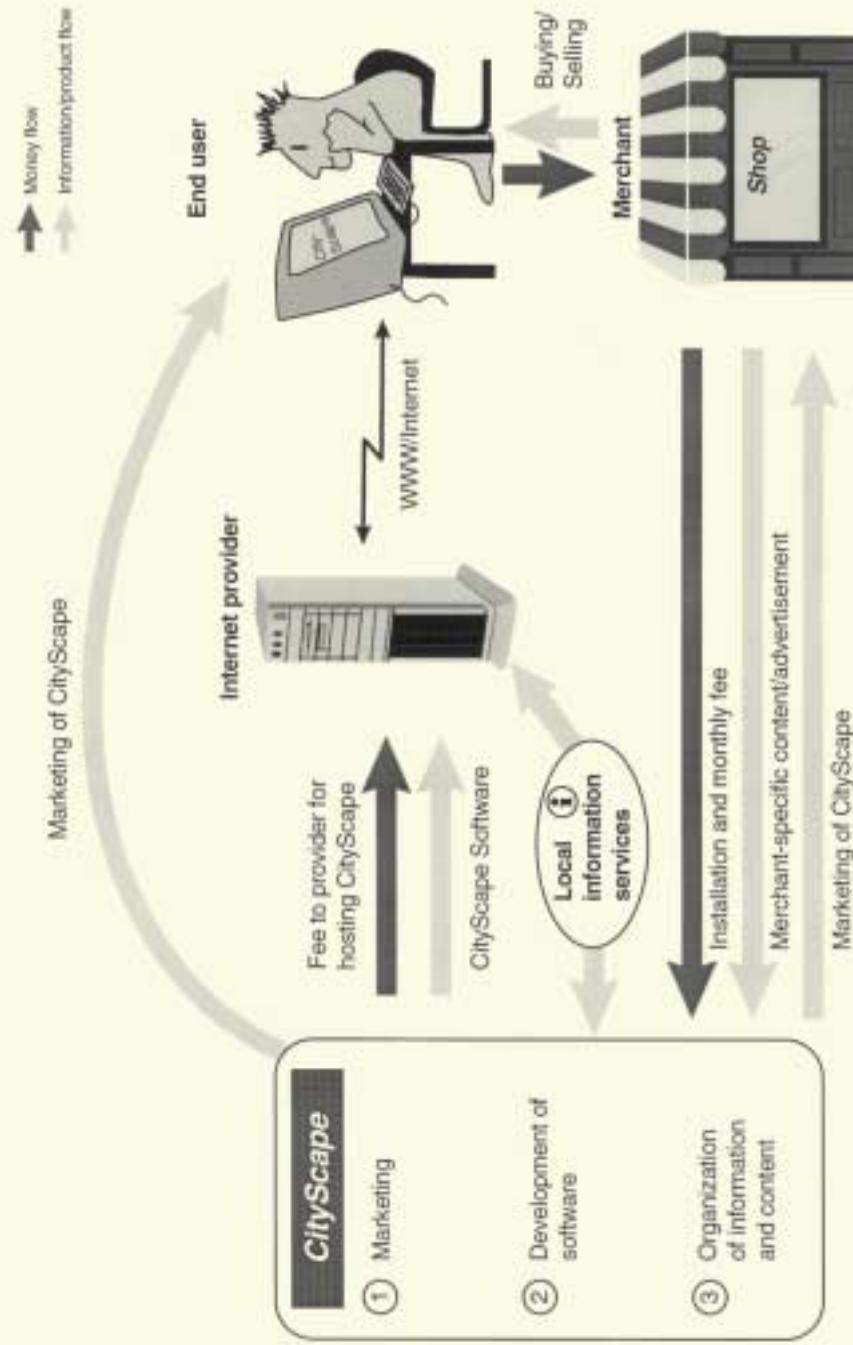
| | Share of ownership | Value (Dfl. m) | Equity (Dfl. m) | IRR |
|----------|--------------------|----------------|-----------------|------|
| Founders | 28% | 13.6 | 0.2 | 132% |
| VC 1 | 43% | 20.3 | 1.5 | 68% |
| VC 2 | 24% | 11.3 | 2.0 | 54% |
| VC 3 | 5% | 2.4 | 1.0 | 34% |
| Total | 100% | 47.6 | 4.7 | 72% |

Exhibit 1

Sample CityScape Homepage

Business Model for CityScape

Exhibit 2



Market estimates for CityScape

Exhibit 3

Number of small to medium-size private businesses with up to 250 employees, thousands

| Sector | Country | The Netherlands | Germany | Belgium | France | Italy | Total | In % |
|----------------|---------|-----------------|---------|---------|--------|-------|-------|------|
| Industrial | | 30 | 225 | 32 | 143 | 539 | 969 | 17 |
| Construction | | 21 | 176 | 26 | 145 | 334 | 702 | 12 |
| Trade | | 74 | 664 | 68 | 373 | 1'512 | 2'691 | 48 |
| Other services | | 145 | 355 | 120 | 157 | 526 | 1'303 | 23 |
| All sectors | | 270 | 1'420 | 246 | 818 | 2'911 | 5'665 | 100 |

Assumptions for CityScape

- Sectors: All sectors except Industrial

- 40% of all businesses are outside of city areas and not reachable or relevant for CityScape

| Potential CityScape customers, thousands | The Netherlands | Germany | Belgium | France | Italy | Total |
|--|-----------------|---------|---------|--------|-------|-------|
| Growth target of CityScape for the first 5 years: 50,000 customers, corresponds to 1.8% of total potential customers | 144 | 717 | 128 | 405 | 1'423 | 2'818 |

Number of cities and communities with over 50,000 people

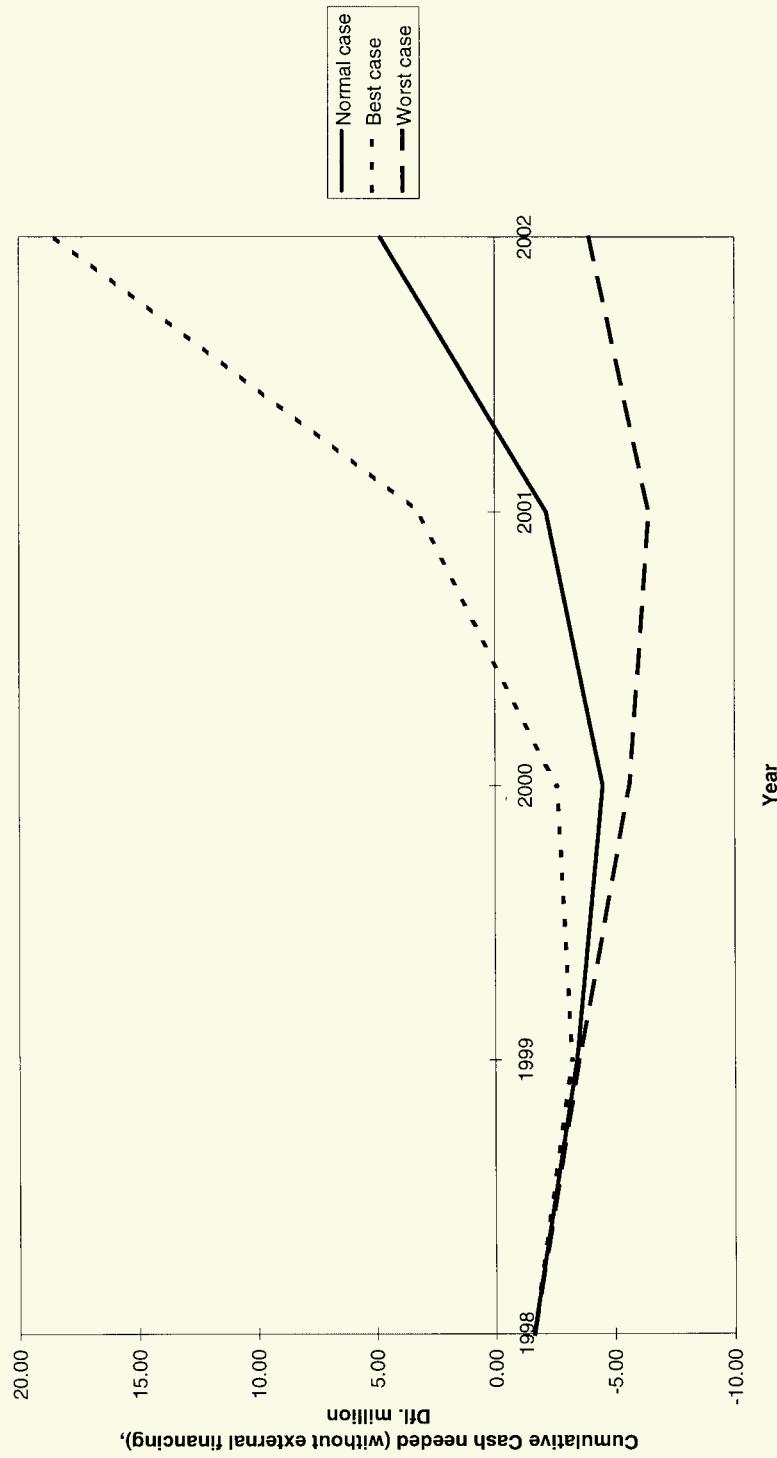
No. of cities Ten biggest cities

| | |
|-----------------|-----|
| The Netherlands | 53 |
| Germany | 150 |
| Belgium | 24 |
| France | 110 |
| Italy | 140 |
| Total | 477 |

In addition to cities certain regions may be target locations for CityScape, too; e.g. Twente, het Gooi in the Netherlands
Overall target for CityScape: 50 cities (regions) in 5 years

Source: Departments of statistics

CityScape Cumulative Cash needed, Dfl. million



| CityScape | | | | | |
|---|--------|--------|--------|-------|-------|
| <i>Cashflow statement (thousand Dfl.) - Normal case</i> | | | | | |
| | 1998 | 1999 | 2000 | 2001 | 2002 |
| BEGINNING CASH | 0 | 116 | 288 | 186 | 255 |
| Sources of Cash | | | | | |
| Net Income | -1'474 | -1'380 | -627 | 3'608 | 7'930 |
| Add Dep/Amort | 17 | 39 | 82 | 120 | 164 |
| Plus Changes In: | | | | | |
| Accounts Payable | 78 | 163 | 227 | 360 | 482 |
| Salaries Payable | 55 | 23 | 62 | 84 | 92 |
| Taxes Payable | 0 | 0 | 0 | 14 | 836 |
| Long Term Debt | 0 | 0 | 0 | 0 | 0 |
| Total Sources of Cash | -1'324 | -1'154 | -255 | 4'185 | 9'503 |
| Uses of Cash | | | | | |
| Less Changes In: | | | | | |
| Net Accounts Rec | 172 | 616 | 736 | 1'684 | 2'389 |
| Gross Fixed Assets | 88 | 58 | 110 | 136 | 147 |
| Total Uses | 260 | 674 | 847 | 1'820 | 2'536 |
| CHANGES IN CASH (CASHFLOW) | -1'584 | -1'828 | -1'102 | 2'365 | 6'967 |
| FINANCING (Equity Investment) | 1'700 | 2000 | 1'000 | 0 | 0 |
| ENDING CASH | 116 | 288 | 186 | 255 | 9'518 |

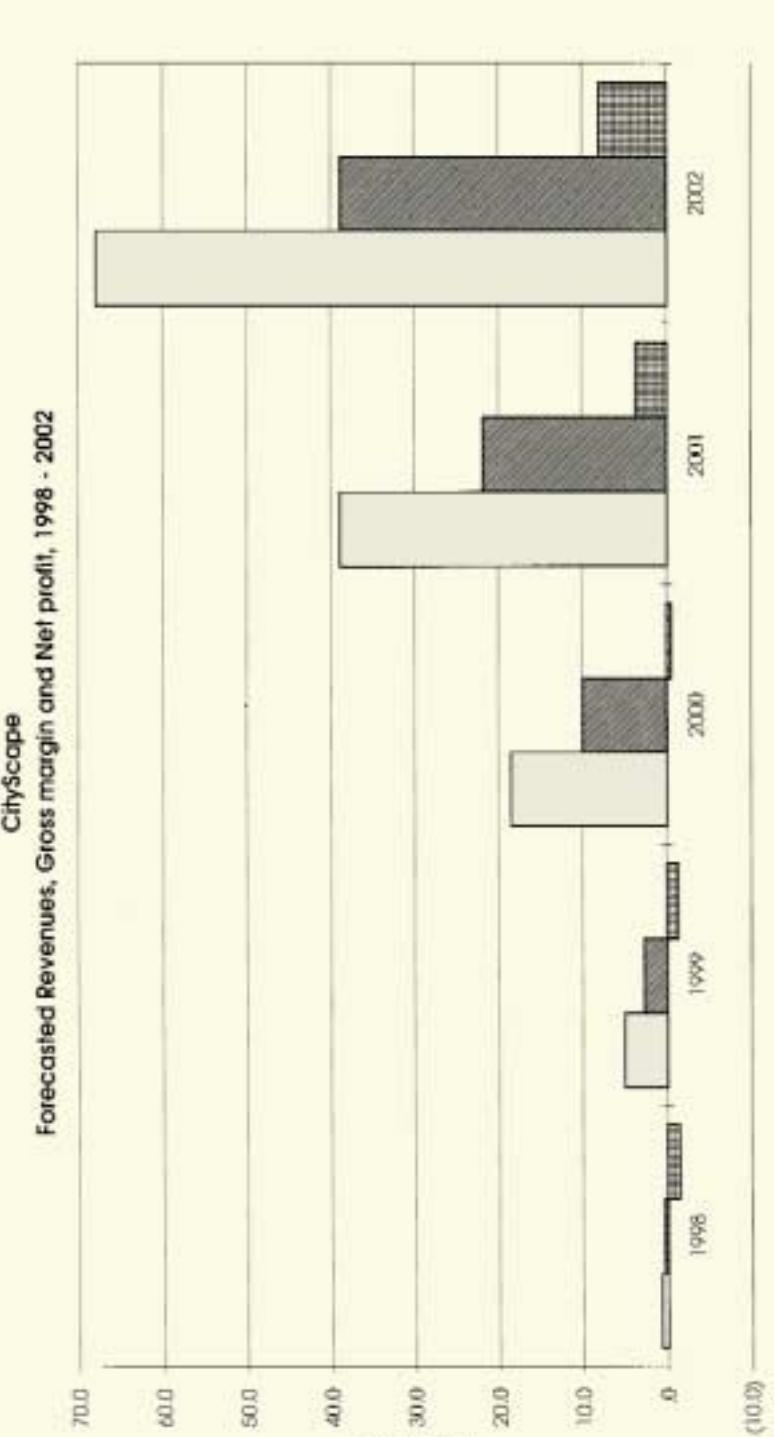


Exhibit 7

| Income statement (thousand Dfl.) - Normal case | | | | | |
|--|-----------------|----------------|--------------|---------------|-----------------|
| | 1998 | 1999 | 2000 | 2001 | 2002 |
| Revenue | | | | | |
| Product 1 - Basic Service | 177 | 1'366 | 4'867 | 10'429 | 18'355 |
| Product 2 - Deluxe Service | 252 | 1'952 | 6'953 | 14'899 | 26'222 |
| Product 3 - Catalog Service | 173 | 1'178 | 3'973 | 8'194 | 14'154 |
| Product 4 - Homepage update | 48 | 464 | 2'682 | 5'364 | 9'118 |
| Total Revenue | 649 | 4'960 | 18'475 | 38'886 | 67'849 |
| Cost of Goods Sold | 340 | 2'296 | 8'537 | 17'074 | 29'026 |
| Gross Margin % of Revenue | 309 48% | 2'664 54% | 9'938 54% | 21'812 56% | 38'823 57% |
| Operating Expenses | | | | | |
| Engineering | 549 | 782 | 1'566 | 3'080 | 4'681 |
| % of Revenue | 85% | 16% | 8% | 8% | 7% |
| Marketing/Sales | 938 | 2'687 | 7'851 | 13'038 | 20'177 |
| % of Revenue | 144% | 54% | 42% | 34% | 30% |
| Administration | 296 | 575 | 1'147 | 2'031 | 2'638 |
| % of Revenue | 46% | 12% | 6% | 5% | 4% |
| Total Operating Expenses | 1'783 | 4'044 | 10'564 | 18'150 | 27'495 |
| % of Revenue | 27.5% | 82% | 57% | 47% | 41% |
| Income Before Int & Taxes % of Revenue | -1'474 -227% | -1'380 -28% | -627 -3% | 3'662 9% | 11'328 17% |
| Interest Exp | 0 | 0 | 0 | 0 | 0 |
| Income Before Taxes | -1'474 0 | -1'380 0 | -627 0 | 3'662 54 | 11'328 3'399 |
| Net Income % of Revenue | -1'474 -227% | -1'380 -28% | -627 -3% | 3'608 9% | 7'930 12% |

CityScape Balance sheet (thousand Dfl.) - Normal case

Exhibit 8

| | 1998 | 1999 | 2000 | 2001 | 2002 |
|-------------------------------------|------------|--------------|--------------|--------------|---------------|
| ASSETS | | | | | |
| Current Assets | | | | | |
| Cash | 116 | 288 | 186 | 2551 | 9518 |
| Net Accounts Rec | 172 | 788 | 1524 | 3208 | 5598 |
| Inventory | 0 | 0 | 0 | 0 | 0 |
| Total Current Assets | 288 | 1076 | 1710 | 5759 | 15116 |
| Gross Fixed Assets | | | | | |
| 88 | - | 146 | 256 | 392 | 539 |
| Less Accum Depreciation | 17 | 57 | 139 | 259 | 422 |
| Net Fixed Assets | 71 | 89 | 118 | 134 | 117 |
| TOTAL ASSETS | 359 | 1'165 | 1'828 | 5'893 | 15'233 |
| LIABILITIES | | | | | |
| Short Term Liabilities | | | | | |
| Accounts Payable | 78 | 242 | 469 | 829 | 1'311 |
| Salaries Payable | 55 | 78 | 140 | 224 | 315 |
| Taxes Payable | 0 | 0 | 0 | 14 | 850 |
| Total Short Term Liabilities | 133 | 319 | 609 | 1066 | 2'476 |
| Long Term Liabilities | | | | | |
| Long Term Debt | 0 | 0 | 0 | 0 | 0 |
| Total Long Term Liabilities | 0 | 0 | 0 | 0 | 0 |
| TOTAL LIABILITIES | 133 | 319 | 609 | 1066 | 2'476 |
| Equity | | | | | |
| Common Stock | 200 | 200 | 200 | 200 | 200 |
| Preferred Stock | 1'500 | 3'500 | 4'500 | 4'500 | 4'500 |
| Retained Earnings | -1'474 | -2'864 | -3'481 | 127 | 8'067 |
| Total Equity | 226 | 846 | 1'219 | 4'827 | 12'757 |
| LIABILITIES & EQUITY | 359 | 1'165 | 1'828 | 5'893 | 15'233 |

CityScape *Financial assumptions*

REVENUES:

- First revenues are generated 6 months after start of operations
- Pricing (Dfl.):

| | Setup | Monthly fee |
|-----------------------------|-------|-------------|
| Product 1 - Basic Service | 100 | 50 |
| Product 2 - Deluxe Service | 400 | 200 |
| Product 3 - Catalog Service | 2000 | 500 |
| Product 4 - Homepage update | | 25 |

COST OF GOODS SOLD:

- Cost of goods sold are the percentages of fees paid to the Internet providers
- Split of fees with Internet providers:

| | Setup | Monthly fee |
|-----------------------------|-------|-------------|
| Product 1 - Basic Service | 75% | 25% |
| Product 2 - Deluxe Service | 75% | 25% |
| Product 3 - Catalog Service | 75% | 50% |
| Product 4 - Homepage update | | 80% |

OPERATING EXPENSES:

- Salaries are based on competitive compensation, e.g. (Dfl.):
 - Founders=6000 (fixed)
 - Salesperson=6000; Accountant, Controller=5000
 - Software-developer, Marketing=8000, Sales manager=9000
- Social costs are 30% of salaries
- Salaries increase by 3% per annum
- The model for the annual number of employees can be found in the financial plan
- Sales commissions are built into the sales salaries
- Consultants and contractors are employed at market rates for special projects
- Operating expenses per person are assumed as follows:

| Expenses per pers./month | Supplies | Travel | Communication |
|--------------------------|----------|--------|---------------|
| Manufacturing | 0 | 0 | 0 |
| Engineering | 200 | 400 | 100 |
| Marketing&Sales | 200 | 1'000 | 600 |
| Administration | 200 | 200 | 100 |

- Rent is assumed at 20 Dfl. per square meter per month
- Reserve for bad debt is 1% of revenues
- Interest revenue is 2% of cash balance
- Combined income taxes are 40%

BALANCE SHEET

- Payables and receivables are settled within 30 days
- Fixed assets include computers, software and office equipment
- Depreciation periods: computers, office equipment=5 years, software=3 years
- Salaries payable are 50% of one month's salary
- Taxes are paid at the end of the tax period

Valuing a start-up and raising equity

Dealing with venture capitalists
and private investors

The good thing about talking to a venture capitalist is that they bring you down to earth. It's not that they're negative, but they'll give you a feel for what it will really need to succeed.

*Eugene Kleiner
Venture Capitalist*

Valuing a start-up and raising equity

A business plan quantifies the financial resources that the business will need. How will you be able to gain access to these resources? You will probably quickly realize that debt, such as bank loans or mortgages, is unlikely to be available to new businesses. The only practical option is often participation by an investor in your company's equity. As this represents a high-risk investment over a period of years for investors, they will require both a certain rate of return and a certain share of the company. You will have to negotiate with investors over this. The basis for such negotiations is a company valuation. In addition to purely financial support, entrepreneurs should also estimate the investor's support in terms of "smart money". As this relationship will probably last over several years, it is essential, during the negotiations, to create a basis of trust for the cooperation.

In this chapter you will find out:

- ◆ How the interests of investors and start-up management teams can differ
- ◆ How to reach a deal
- ◆ How to value the business in preparation for the negotiation
- ◆ What to watch out for in the negotiations
- ◆ How to raise further capital.

DIFFERING INTERESTS

When you have prepared a business plan for your enterprise, you will need to get an investor involved. You will need to identify suitable investors, arouse their interest, and negotiate with them. No-one is going to make funds available for free. All that the management team has to offer in return for the investor's cash is promises – not normally an advantageous negotiating position. Nevertheless, you can generally expect to get a fair deal, because professional investors are interested in seeing that the team as a whole is successful.

The management team's interests

If you are happy with a small company, then you will probably be well advised to make use of family funds, loans from friends and personal bank loans. This way, you retain the majority holding in the company, but significantly restrict your ability to grow. You should check whether "cheap" money is available anywhere else, like, for example, from state development funds. Start-ups sometimes have recourse to what are known as "business angels" – private investors and retired entrepreneurs who usually invest smaller amounts compared to venture capitalists, but with less demanding information requirements. They can also use their experience to help with non-strictly financial questions.

If, however, you want to expand quickly, you will generally need the help of venture capitalists, or similar types of investor. First, stop and think whether you really need as much capital as you think you do. A venture capitalist will want a significant share of your company – you may not even be able to keep the majority holding. However, professional investors are not generally interested in running the company, as long as you meet your targets.

Bear in mind that the negotiations are not just about money. It is important for you that an investor is prepared to give your management team active support – and is in a position to do so geographically – and can also provide the necessary expertise (e.g., legal or marketing knowledge) and contacts. This element, known as "smart money", is particularly important at a time when the management team is forced to rely on outside experience and support. In retrospect, this, and good chemistry between management team and investor, will probably seem much more important to the success of the business than the size of the investment.

Consider these points:

- ◆ To what extent are you prepared to give up ownership of the company?
- ◆ What non-financial support are you also looking for from your investor?

The investor's interests

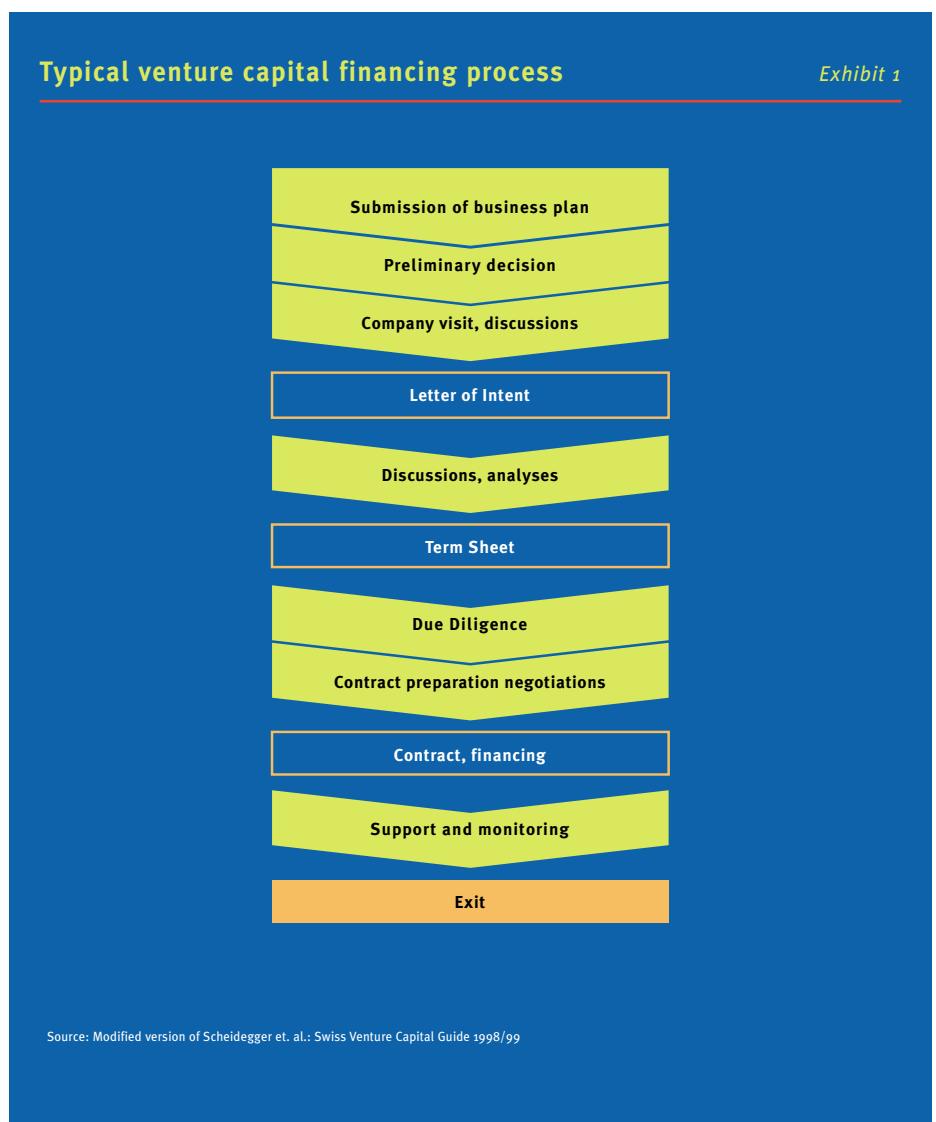
Investors require a return that matches the risk involved. However, there are significant differences between investors, generally over the following matters:

- ◆ Type and extent of acceptable risk
- ◆ Size of investment
- ◆ Extent and content of additionally agreed rights and requirements, particularly with regard to possibilities of exerting influence (see "Term Sheet" in "The Way to the Deal")
- ◆ Time horizon for the required return.

In addition to financial interests, many investors, such as industrial groups, have other reasons for their involvement – strategic ones for example. It may be a way, for instance, for an industrial group to keep a "window on technology" open – a window on new technologies and markets, but also on possible competitors.

THE WAY TO THE DEAL

If your business plan has aroused an investor's interest in your business and your team, the next step is initial discussions and negotiations. The investor will confirm his intention to embark on serious negotiations with a Letter of Intent (*Exhibit 1*).



After an initial review, a preliminary contract, known as a Term Sheet, is generally concluded (example on pp. 188–190). This sets out the financial aspects of the participation – the size and form of the investment and the investor's resulting share of the business. It also regulates other important points, such as:

- ♦ Monitoring, information and decision-making rights
- ♦ Possible limitations on liability of the parties to the contract, confidentiality declaration
- ♦ Type and extent of management support
- ♦ Arrangements for any distribution of profits, stock option plans, powers of disposal and increases in capital
- ♦ Duration of investor's involvement, disposal and termination rights
- ♦ Procedure for additional financing.

Before deciding on an involvement, the investor will review the business plan again in detail: this is known as a Due Diligence review. When all the responsible bodies at the investor have approved the preliminary contract, negotiations have clarified the open questions, and the team has met the preconditions set out in the Term Sheet, the financing phase moves to the next stage, the closing, with the signature of the shareholders' commitment contract. One of the most important elements in the whole process is mutual trust and confidence, for the deal is the start of an intensive cooperation over a period of years.

Term Sheet (Preliminary Contract) between Venture Capital Example and Start-Up Company

Set out below are the main elements concerned in a participation by Venture Capital Example – hereinafter VCE – in Start-Up Company – hereinafter SUC. Final agreement is dependent on the fulfillment of the conditions set out in this preliminary contract. This preliminary contract is based on the information contained in the project plan of ... 1999, and on further documents included in the appendix.

Company: The legal form of SUC shall be The domicile of the company shall be ... The applicable jurisdiction shall be ...

Placement and supplementary financing: VCE shall make available to SUC funds to the amount of ... ; this represents ... shares with a value of ... per share.

The founders may also make an investment of ... The same conditions shall apply for such an investment as for that of VCE.

In future financing rounds ...

- ❖ Definition of decision-making process
- ❖ Determination or reallocation/adjustment of shares

Shares in the business: On the assumption that both the founders and the investor make investments, regardless of the chosen legal form, the shares in the company shall be as follows:

Founders: ...%

Investor: ...%.

Use of profits: Concerning the use of future profits, it is agreed that ...

Stock option plan: The board, the supervisory bodies and the employees shall be allocated up to ... % of the equity on the basis of a stock option plan (see the appendix for the applicable provisions). The special exercising rights for the stock options apply for ... years.

General management:

Mr/Mrs... is appointed as general manager of the company

Management team:

The founders of SUC are ...

Supervisory body:

Until further provisions are made, the supervisory body of the company shall consist of ... members. VCE is entitled to appoint ... members, and SUC shall appoint ... members. A further ... people shall belong to the body, in the capacity of independent experts, who shall be appointed by agreement between VCE and SUC.

Investor rights agreement

On closing, the partners shall agree on an investor rights agreement, that shall include the following points:

- ❖ Distribution of voting rights in the annual general meeting and provisions concerning the right of veto
- ❖ Partners' right of first refusal
- ❖ Provisions concerning joint sale
- ❖ Provisions concerning the recall of shares in the business
- ❖ Contractual agreements and applicability of the contract

Powers of disposal:

For all disposals, transfers and sales of shares in the business, the following consensus-based decision-making process shall apply:

- ❖ ...

Right of first refusal:

Should a partner wish to dispose of shares, he or she shall first offer those shares he or she wishes to dispose of to the other partners. Should the other partners take up this offer only in part, or not at all, the procedure shall be ...

Joint sale provisions:

Should there be an interest on the part of third parties in purchasing shares, the procedure shall be defined in accordance with the following points:

- ❖ Provisions for the decision-making process
- ❖ Duration of the provisions

| | |
|---|---|
| Provisions concerning patents and other protective agreements: | Concerning the patents and other inventions made in the course of work performed for the company or in the company's area of activity and the company's resulting protective agreements, agreement is reached on the following: |
| | <ul style="list-style-type: none"> ❖ Rights and duties concerning the provision of information ❖ Property rights in the patents and agreements |
| Confidentiality declaration: | The founders, the investor, all members of the supervisory body, and ... shall maintain confidentiality and shall sign an appropriate confidentiality declaration in this regard. |
| Particular agreements: | Mutual agreements have been reached on the following points: <ul style="list-style-type: none"> ❖ Penalties for contravention of agreements reached ❖ Negotiations with third parties ❖ Exclusivity, where appropriate ❖ ... |
| Closing: | <p>The closing of this transaction (hereinafter "closing"), on which both parties shall agree, shall be achieved by at the latest.</p> <p>The following shall be regarded as preconditions for the closing:</p> <ul style="list-style-type: none"> ❖ Availability and accuracy of documentation and information ❖ Approval process before signature of contact ❖ Conclusion of part-agreements (e.g., patents) ❖ ... |
| Costs: | In the event of closing, ... shall bear all the legal costs and other expenses related to the conclusion of the contract. |

VALUING THE BUSINESS

With their experience of company valuations, venture capitalists can quickly get a picture of what a company is worth, and what share in it they will be looking for. Venture capitalists thus go into negotiations with very clear ideas. Your management team is most unlikely to have access to such experience. So you will need to arrive at your own idea of what your business is worth, and consider how large the investor's stake should be, and what form it should take. To do this, you will need to make your own estimates.

Venture capitalists' procedure

In assessing a start-up, venture capitalists usually apply the following criteria:

- ❖ Is the management team experienced, competent and ready to implement the planning and take personal risks?
- ❖ Is the market attractive and capable of expansion? Does the product provide a platform for further development?
- ❖ Is there a sustained competitive advantage, capable of further development?
- ❖ Are the strategy and the operational planning convincing?
- ❖ How far has implementation already progressed, and what are the initial results (e.g., patents or customers)?
- ❖ Is the expected return realistic and a subsequent sale possible?

The venture capitalist will review these criteria in detail, and decide how far your business meets each one of them. How much the business is worth will generally be decided highly pragmatically, on the basis of empirical values and the investor's current competitive situation. These values may vary widely, depending on the sector and the phase of its existence in which the start-up finds itself. *Exhibits 2 and 3* below show some sample figures for start-ups in the areas of information technology and life sciences. Note that these are values for fast-growing, successful businesses, that are operating in dynamic sectors and will quickly be ripe for a stock market listing. The dynamics in these sectors also mean that these values can change quickly. The range of values quoted show

Possible development of the value of fast-growing IT start-ups in Germany

Exhibit 2

| Development phases Financing rounds | Seed | Start-up First stage | Expansion 2nd stage | Later stage | IPO or sale | Total |
|--|-------|-------------------------|------------------------|-------------|-------------|----------|
| Value of business (pre-investment) | | | | | | |
| Dfl. million | - | 1-40 | 30-160 | 100-430 | 170-1000 | 170-1000 |
| Investment | | | | | | |
| Dfl. million | 0.5-1 | 1-10 | 10-20 | 20-30 | 20-40 | 50-100* |
| Value of business (post-investment) | | | | | | |
| Dfl. million | - | 2-50 | 40-180 | 120-460 | 190-1040 | 190-1040 |
| Investor's share of the business | | | | | | |
| | - | 20-50% | 30-50% | 35-70% | 40-75% | 40-75% |
| Management team's share of the business | | | | | | |
| | 100% | 50-80% | 50-70% | 30-65% | 25-60% | 25-60% |
| Value of management team's share | | | | | | |
| Dfl. million | - | 1-40 | 20-125 | 40-290 | 50-620 | 50-620 |
| Duration of the phase | | | | | | |
| Years | 1-2 | 1-2 | 1-2 | 1-2 | - | 4-8* |

*Cumulated over the whole period

Source: McKinsey New Venture, Spring 1999

Possible development of the value of fast-growing Life Science start-ups in Germany

Exhibit 3

| Development phases Financing rounds | Seed | Start-up First stage | Expansion 2nd stage | Later stage | IPO or sale | Total |
|--|-------|-------------------------|------------------------|-------------|-------------|----------|
| Value of business (pre-investment) | | | | | | |
| Dfl. million | - | 10-70 | 70-260 | 150-620 | 250-1400 | 250-1400 |
| Investment | | | | | | |
| Dfl. million | 0.5-1 | 10-20 | 20-40 | 30-50 | 40-80 | 100-190* |
| Value of business (post-investment) | | | | | | |
| Dfl. million | - | 20-90 | 90-300 | 180-670 | 290-1500 | 290-1500 |
| Investor's share of the business | | | | | | |
| | - | 20-50% | 35-50% | 40-70% | 50-80% | 50-80% |
| Management team's share of the business | | | | | | |
| | 100% | 50-80% | 50-65% | 30-60% | 20-50% | 20-50% |
| Value of management team's share | | | | | | |
| Dfl. million | - | 10-70 | 45-200 | 50-400 | 50-750 | 50-750 |
| Duration of the phase | | | | | | |
| Years | 1-3 | 1-2 | 2-3 | 2-3 | - | 6-11* |

*Cumulated over the whole period

Source: McKinsey New Venture, Spring 1999

that there can be wide variations from business to business. Depending on how well it meets the given criteria, a venture capitalist will locate the start-up at either the upper or the lower end of the typical range for the sector concerned.

Calculating the value of the business yourself

The value of a company is generally understood to mean the market value of its equity (“equity value”). You can get a first feeling of how highly venture capitalists will value your business from colleagues: talk to other management teams that have recently taken up capital. But you also need to do some calculations yourself. As start-ups are not listed on the stock exchange, their market value can only be defined indirectly, by means of a company valuation. Some investors doubt the value of such calculations, pointing out that the figures they produce can raise unrealistic expectations – for, regardless of your calculations, your business is only worth what an investor is prepared to pay for it after the negotiations! Thus, the point of your calculations is not so much to define the “right” value for your business, as to get a feeling for the factors that determine its value. Work on the basis that the way is the goal.

Also, doing your own calculations will give your management team clarity at an early stage on what percentage of the business you will probably need to sell to “outsiders”. You can work through the financing possibilities, and take alternatives into account. Lastly, you will have a factual basis that will enable you to represent your position more confidently in the negotiations. But do not overdo your efforts here – in this phase, you need to devote your time above all to the business itself!

Both theory and practice combine various methods to value a company. Start-ups are frequently so dynamic that using one process only can easily lead to false conclusions. You should use:

- ◆ The Discounted Free Cash Flow method (DCF)
- ◆ Estimating with multiples.

The mechanics of both types of calculation are shown in simplified form below, using a fictional new business in the IT sector (*Exhibit 4*). The individual stages are presented in the separate boxes.

Figures for the sample IT business

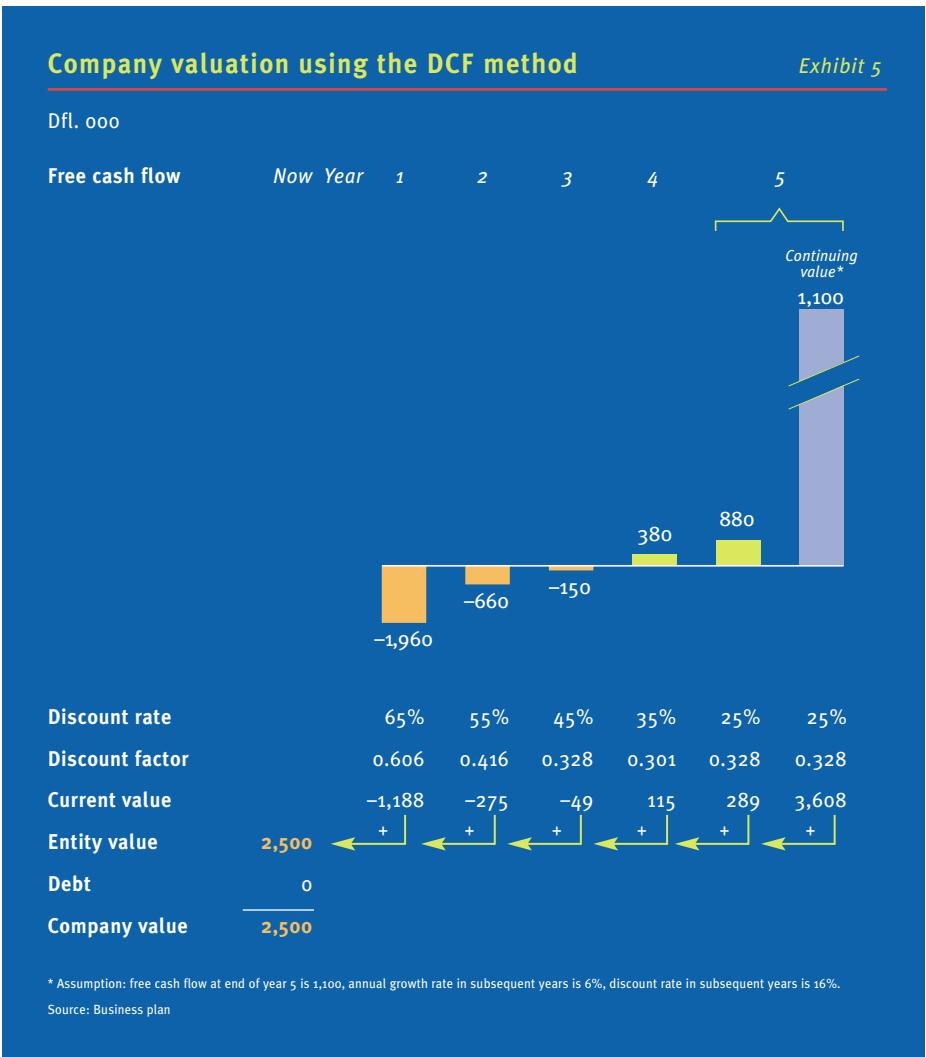
Exhibit 4

| Dfl. 000 | 1 | 2 | 3 | 4 | 5 |
|-----------------------------|--------|--------|-------|-------|-------|
| Year | | | | | |
| Free cash flow | -1,960 | -660 | -150 | 380 | 880 |
| Net profit (annual surplus) | -1,580 | -1,490 | -640 | 340 | 905 |

Calculating with Discounted Free Cash Flows (DCF)

From an investor’s perspective, it is not the fixed assets of a business (offices, equipment, etc.) that determines its value, but rather the cash flow that can be achieved with these assets. Cash is the means by which you pay investors for their investments. This requires a forward-looking perspective, as can be seen from time to time on the stock exchange: a company’s share price falls although it is currently successful – investors take the view that the future cash flow will be less than forecast. Net profit (or the annual surplus) itself is only of significance in determining value to the extent that it enables a more exact estimate of the cash flow.

In the DCF method, all the future free cash flows (see DCF box) are defined, discounted and added together. The result is the “entity value” – the value of the equity plus the debt. The value of the business – the “equity value” – is arrived at by subtracting the debt.



Cash flows typically occur at different times, as shown in *Exhibit 5*. Simply to add them together would be much the same as adding up apples and oranges. Future values must be recalculated – discounted – to their current value (see chapter 8, pp 125 ff.). Applied to our sample business, discounting the future cash flows to the current value gives the company value of some Dfl. 2.5 million shown in the diagram.

The discount rate to be used can be a matter of controversy. In the start-up phase, it is mainly dependent on the profitability expected by investors, the risks of the business, and the returns from comparable enterprises. Venture capitalists often use the return they expect as the discount rate: depending on the development stage of the business, the industry involved and the known risks, this may be between 30% and 75%. In general, the higher the risk, and thus the expected return, the lower the current value of the business.

Venture capitalists justify such – apparently high – discount rates for reasons such as:

- ◆ Newly started companies are more risky
- ◆ Unlike shares in listed companies, shares in start-ups are not really tradable, and therefore not liquid
- ◆ They need to give the management team intensive support during the period of their investment
- ◆ The founders' forecasts are often over-optimistic and need to be revised.

So consider, before the negotiations, which of the risks set out in the business plan you have already been able to either avoid altogether or minimize by your actions as an entrepreneur.

The DCF method can be problematic for start-ups in the initial phase: new businesses typically start with negative cash flows and very uncertain forecasts, as there is no past history to fall back on. Apply it all the same, though: it will give you a better understanding of the assumptions implicit in your business plan, and the factors that influence the value of your business. By using it together with estimates using multiples, and the empirical values of your colleagues, you can get a clearer definition of the range in which the value of your business lies.

In the subsequent growth phase, the DCF method described here will no longer suffice, as the capital structure (e.g., taking on debt), tax rate and growth rate of your business will increasingly change. You can find more information on a refined DCF methodology in, for instance, the standard reference work “Valuation: Measuring and Managing the Value of Companies” by Copeland, Koller, Murrin.

The Discounted Cash Flow method (DCF)

In the business plan, you have already calculated your cash flows. The DCF method uses these to determine the value of the business, using the total of the discounted cash flows minus the debt.

1. Determining the current value of future cash flows

- ◆ Decide the period for which you can make reasonably certain forecasts of your cash flow (forecast period). For start-ups this would typically be a period of 5 to at most 10 years.
- ◆ Determine the free cash flows for these years. These are the same as the operational cash flows indirectly derived for the business plan (see p. 148).
- ◆ Set a discount rate for each year that reflects the risk level. This rate should be reduced by 5–15% per year in subsequent years, as the initial risk level will fall continuously (e.g.: $r_1 = 65\%$, $r_2 = 55\%$, ...). At the end of the forecast period, the rate would typically not be more than 10–20%.
- ◆ To set the discount factor for each year, use the general formula:

$$\text{Discount factor} = \frac{1}{(1+r)^t} \quad \text{where } r = \text{discount rate in percent and } t = \text{the year in which e.g. the cash flow occurs.}$$

In our example, the discount factors for the first years are:

$$\frac{1}{(1+0.65)}, \quad \frac{1}{(1+0.55)^2}, \quad \frac{1}{(1+0.45)^3}, \dots$$

- ◆ The current value of the free cash flow for each year is given by multiplying the free cash flow by the discount factor for the year in question.

The Discounted Cash Flow method (DCF) (continued)

2. Calculating the continuing value

- ◆ To take account of the cash flows after the forecast period, what is known as a continuing value is used. This is approximated with the following formula:

$$FW_t = \frac{FCF_t \cdot (1+g)}{r-g}$$

where FCF_t = free cash flow at the end of the last forecast year (in the example $t = 5$), r = discount rate, and g = annual rate of growth of the cash flow for the subsequent period (in the example 6%). As this continuing value applies for the end of year 5 or the beginning of year 6, it must be discounted with the appropriate discount rate (r) for year 5, so you should multiply the continuing value by

$$\frac{1}{(1.25)^5}$$

3. Determining the actual value of the business (“equity value”)

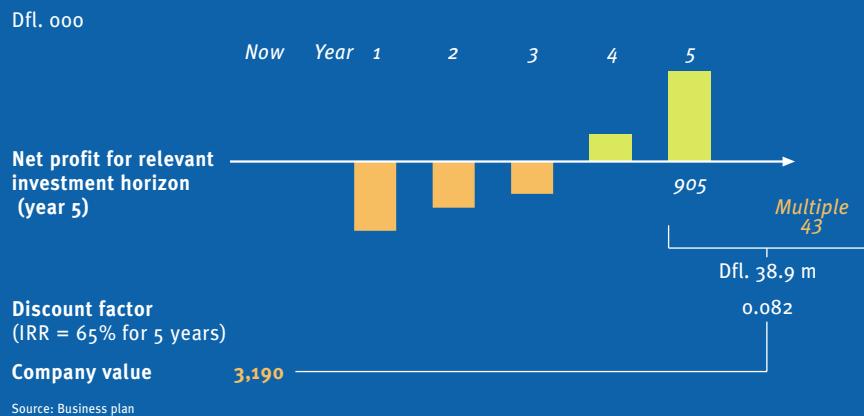
- ◆ The value of the business is the total of all the discounted cash flows during the forecast period plus the continuing value minus the debt.

Estimating with multiples

The value of a business can also be estimated with the aid of comparable values from already established businesses, known as multiples. One possible such comparable value is the price/earnings ratio (PER), others are listed in the “Multiples” box on page 203. Usually, when using this method, you multiply the appropriate value for your business (e.g., the net profit) with the corresponding multiple. This gives you the value of the business (“equity value”) at the end of your investor’s investment horizon, known as the exit point (the investment horizon is typically between 5 and 10 years). This value is then discounted to give the current value of the business.

Company valuation using multiples

Exhibit 6



In the case of our sample IT business, there are two comparable companies in the market, with PERs of 37 and 49. The average of these two values, 43, is used for the calculation (Exhibit 6). By way of comparison: the average value (median) of the PERs on the Neue Markt (Frankfurt) at the end of 1998 was about 40. Multiplication by the net profit in, for example, year 5 produces a future value for the business of about Dfl. 39 million in year 5. As with this method only one value is discounted, the discount rate must reflect the total risk; in our example, the expected return is 65%. Discounted, the current value of the business is some Dfl. 3.2 million.

Multiples

The value of the business is often also approximated on the basis of comparable values from established businesses, known as multiples. Frequently used multiples are the price/earnings ratio (PER) and the market value to sales ratio.

1. Determining the future value of the business using multiples

- ◆ Search the market for companies as like your business as possible, in terms of sector, product range, risk, growth rate, capital structure, and cash flow forecasts. Good sources are the annual reports of listed companies, or the analysts' reports of banks.
- ◆ For the comparable company, form the desired multiple for the year in which it was listed on the stock exchange: for example the PER. It is a necessary condition for using the PER that the company is profitable.

$$PER = \frac{P}{G}, \text{ where } G = \frac{\text{net profit}}{\text{no. of shares}} = \text{earnings per share, and } P = \text{current stock price}$$

If you have identified several companies, you can form an average. Consider for what reasons, if any, your multiple might be higher or lower in the year of stock exchange listing and if necessary, adjust the multiple.

- ◆ Multiply the net profit shown in your business plan for the time of the investor's exit by the comparable PER. The future value of the business (FV) is $PER \times \text{net profit}$.
- ◆ Alternatively, use other multiples , e.g

$$FV = \frac{\text{Market value of the equity}}{\text{sales i}} \times \text{sales j}, \\ \text{where i = comparable business and j = your business or}$$

$$FV = \frac{\text{Market value of the equity}}{\text{Average no. of i "clicks" on the homepage per week}} \times \text{no. of j "clicks" per week}$$

Possible multiples result from the relationship between the market value of the equity and the number of customers or of staff, or the R&D costs.

Multiples (continued)

2. Discount the value of the business to current value

- The calculated figures represent the value of the business in the year of exit of your investor (e.g., year 5). Set a discount rate that reflects the risk involved (r), and calculate the appropriate discount factor, e.g.

$$\frac{1}{(1 + 0.65)^5}$$

- The current value of the business ("equity value") is reached by multiplying the calculated future value of the business by the discount factor.

Synthesis of the various values of the business

The calculations produce the following values for the business:

Calculated equity value

| | |
|--|---------------------|
| Discounted cash flow | c. Dfl. 2.5 million |
| Multiples with average values of comparable business | c. Dfl. 3.2 million |
| Average of both processes | c. Dfl. 2.9 million |

The range of values (post-investment) for the business of Dfl. 2.5–3.2 million thus calculated provides a good basis for discussions with investors. Such a value is realistic to the extent that we assume that we are dealing here with a new company, with little experience, and that has so far gained few customers.

How to get a better feeling for figures

- Calculate the value in several different ways to get a clearer idea of the range of values, and compare your results with experience from your sector
- Play through various scenarios, taking account of the optimum development track for the business ("best case"), and also the delays or other obstacles involved if everything possible goes wrong ("worst case")
- Where possible, check your results with experts
- Talk to other management teams in comparable situations who have already negotiated with investors
- If your value is at either the upper or the lower end of the spectrum, consider why this is so.

Bear in mind that the worth of such a valuation depends largely on the plausibility of your assumptions. What assumptions are implicit in your calculations? If your assumptions for the first round of financing are too optimistic, and you are later unable to meet the expectations you have raised, you will lose your credibility, which will be a major obstacle in subsequent financing rounds.

Calculating the investor's share

Mathematically speaking, the investor's share is calculated on the basis of the size of the investment (need for funds) and the current value of your business, using this formula:

$$\frac{\text{Investment}}{\text{Value of business}}$$

Let us assume that an investor is interested in providing the first tranche of capital required by our sample business, Dfl. 1 million. What share of the business might he expect in return?

Use a good accountant or book-keeper, and a good lawyer, and listen to their advice. Get help in those areas in which you aren't familiar

*Martha Johnson
Owner, Suppers Restaurant*

Investor's share

| | |
|---------------------------------------|---|
| Post-investment value of the business | Dfl. 2.9 million |
| Investment | Dfl. 1 million |
| Investor's share | $p = \frac{\text{Investment}}{\text{Post-investment value}} = \frac{1}{2.9} = 34\%$ |
| Management team's share | $1-p = 66\%$ |

Different approaches by venture capitalists and the management team in calculating the shares can give rise to misunderstanding. The venture capitalist generally calculates the value of the business before the investment – known as the “pre-investment” value. What the venture capitalist is really interested in is what the business is worth on its own. Then he adds on the investment and thus arrives at the “post-investment” value.

You, on the other hand, will arrive automatically at the post-investment value if you use the DCF and multiples processes described here in your calculations. This is because your cash flow and net profit forecasts are based on the assumption that the necessary capital – your own and that of outside investors – is available, and that all the necessary and planned realization steps, such as purchasing equipment or carrying out publicity campaigns, can be implemented. Be sure that the same value is being used by both sides in any discussion.

Some investors will offer you an investment based on performance: if you achieve the agreed targets (“milestones”), the originally calculated management share applies. If your business is less successful, the investor's share will, after a review, be increased.

There is one thing you should not overlook in all these calculations. Ultimately, the value that matters is the one you agree on with your investor, regardless of your previous calculations. The calculations enable you to get a feeling for the value of your business, and provide a basis for your arguments. Be self-critical: after you have done the calculations, ask yourself whether you would be prepared to make an investment of Dfl. 1 million in return for, for example, a 34% share of your business.

THE NEGOTIATION

You have prepared your business plan, and your estimates of the value of the business and the capital you need have given you a clearer idea about participation by investors. Now, you can approach investors: if they are interested in your business, they will have their own idea of its value. Neither of the values arrived at should be regarded as absolutes. They simply provide starting points for what can often be a tedious negotiation process, in which the differing interests can be brought together.

Negotiating with investors is sometimes described as a race between greed and fear – on the one hand the management team’s fear that they will not be able to get the finance they need, and on the other, their wish not to give away too much of the business too quickly and too cheaply. Raising capital in stages is thus advantageous, though it involves repeated rounds of negotiation. But you should at all costs avoid playing off the different interested investors against one another. Talk to several investors, though; these discussions will quickly show you where you are being realistic, and where you may have got somewhat “carried away”.

Essential elements of the negotiations are soundly based arguments and the personal conviction of the management team, the urgency of their need for capital, the maturity of the business idea (e.g., existing customers, patents), and the return expected by the investor. Lastly, there are two decisive factors:

1. How much “demand” is there for your business? This depends on how many investors you have been able to interest in your business, and how realistic your expectations of them are. A convincing business plan, presented by a committed and competent management team, is the most effective means of communication.

2. How far will you be able to convince investors of your intentions?

When preparing and during the negotiations, put yourself in your discussion partner's position: the better you understand his interests, the more likely you are to be able to reach a solution acceptable to both sides. Be ready to compromise. A commitment by an investor will generally be for 5–8 years, so mutual confidence is essential. This is particularly the case inasmuch as your investor's advice and support (the "smart money") will ultimately be at least as important for your business as his financial contribution.

A deal can become very complicated; it is always a good idea to make contact with experienced entrepreneurs, and get expert advice from accountants, tax specialists and lawyers – particularly once the Term Sheet is signed. Do not be afraid of complex constructions; there is usually a legitimate reason for them – such as tax breaks, or control over the funds invested. But make sure that you are absolutely clear about all the details of the deal.

RAISING CAPITAL FROM ADDITIONAL INVESTORS

Your business will probably need to raise further capital in the years ahead, in order to finance its subsequent development. Raising capital is thus not a one-time exercise – there will be further negotiations and capital increases in the growth period.

For further capital increases, you will need to revalue your business, define the shares, and agree with the investor on a contract.

Procedure for further capital increases

The assumption is that, after eighteen months, our sample business will need to raise a further Dfl. 2 million from another investor.

- ◆ Redefine the relevant values – using the free cash flow for the coming years, the net profit and sales – and the discount rate for the intended investment horizon. This will take the development so far into consideration. Calculate the current value of the business as described.

Example: The recalculated values for the forecast period produce a post-investment value for the business of about Dfl. 10 million.

- ◆ Determine the shares in the *value according* to the investments involved.

Example: The business is worth Dfl. 10 million, Dfl. 2 million of this belongs to Investor B. Of the remaining Dfl. 8 million, Dfl. 5.3 million belongs to your management team (previous share of 66% times 8 million) and Dfl. 2.7 million to Investor A.

- ◆ Determine the *percentage* shares.

Example: Investor A has 27% (Dfl. 2.7 million of Dfl. 10 million), Investor B 20% (Dfl. 2 million of Dfl. 10 million), and you have 53%.

Repeat this procedure for each subsequent increase of capital.

We know we will have to give up a significant stake in the company, but we're willing to do it on the theory that a small piece of a big pie is better than a big piece of a small pie.

*Larry Leigon
President, Ariel Vineyards*

Your share of the business decreases with each further increase of capital. After the second round, you only have 53% of the business, for example. Do not be alarmed by this: this smaller percentage has a greater absolute value – the investments are financing your growth.

Checklist for valuing the business and raising equity

Do your ideas and calculations answer the following questions?

- Who are the investors you want to deal with?
- Can the investor achieve his target return, and satisfy his other interests with your business?
- What is a realistic value for your business? What assumptions are the calculations based on?
- What investment will you get for what percentage of your equity?
- What additional contribution can the investor make, apart from his financial commitment (“smart money”)?
- What are the contractual arrangements for the investor’s exit, and for further increases of capital?

Appendix

The hardest thing
to see is what is
in front of your eyes.

Goethe

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GLOSSARY

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| Agent | Intermediary in distribution/sales who does not belong to one's own firm; as a rule, an Agent also distributes products or services from other suppliers |
| Asset | Items belonging to a firm that have a commercial or exchange value; typically classified as Current assets or fixed assets |
| Balance sheet | A financial statement of accounts that shows the Assets and liabilities of a company on a given day |
| Bank limit | Credit line commitment up to a maximum amount; interest is charged only on the amount actually borrowed |
| Bankruptcy | Cessation of all payments by a company as a result of its inability to pay its Debts , followed by liquidation of the company's Assets |
| Best case | Business scenario based on the assumption that the majority of events affecting the targeted result will be positive |
| Book profit/loss | Profits (losses) resulting solely from adjusting accounting records to reflect the increase (decrease) in the value of an Asset or liability |
| Bookkeeping | Function or technique applied to measure and describe the financial position and success of a company |
| Break-even | In the context of a start-up : point in time when positive Cash flow is achieved; generally: point in time when the profit threshold is crossed and a profit is realized |
| Burn rate | Speed at which money is spent; e.g., expressed in guilders per month |
| Business angel | In the context of a start-up: a wealthy individual who provides venture capital; non-professional venture capitalist |
| Business plan | Report or working paper that clearly and concisely presents all aspects of a new company that are important for investors; information about the product idea, the market, the people who will manage and run the business, growth prospects, financial analyses, etc. |
| Business system | Description of the individual activities of a company and their interdependencies; the business system shows which work is performed in what sequence to produce a product or provide a service |

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| Call centre | Office with a telephone bank capable of handling a large volume of calls; typically set up and run to accept orders resulting from direct sales (e.g., mail-order businesses) or to provide information and make reservations (telephone companies, airlines) | Distribution channels | Physical path that a product moves along from the supplier to the customer |
| Cash flow | Net change in a company's cash account during a defined period; takes into account all changes in cash in operations, investments, and financing | Early stage | In the context of start-ups : phase in the development of a company from the founding of the company to market entry and initial market success |
| Competitor analysis | Observation and comparison with rival firms in the same sales market with the aim of understanding their strengths and weaknesses more thoroughly | EBIT | Earnings before interest and taxes |
| Copyright | A form of protection of intellectual property that prohibits unauthorized imitation of an idea, a name, or a product | EBITDA | Earnings before interest, taxes, depreciation, and amortization |
| Current assets | Assets that can be easily converted to cash or cash equivalents in the normal course of business activity | Equity capital | Pure assets of a company: assets minus debts; equity capital consists of capital stock, statutory reserves, other open reserves, profit brought forward, and hidden reserves |
| Current liabilities | Also referred to as short-term Debt ; debts or other obligations that must be repaid within a business year (creditors, open accounts) | Exit | In the context of a start-up: divestment; sale of shares in a business and realization of profits by investors |
| Customer segments | Distinct customer groups (= segments) within a market that each have common distinguishing features in categories such as geography, socio-demographics, or behaviour, e.g., preferences | Exit strategy | Investor's plan for realizing a profit on an investment |
| Customer value | Utility (or benefits minus price) of a product offering for a customer as defined by supplier or perceived by customer or both | Expansion phase | Further intensive growth of a (new) company, e.g., after its initial successes on the market (for new companies, this phase follows the start-up phase) |
| Debt | External financing ; outside capital made available to a company in exchange for fulfilment of an obligation, e.g., repayment with interest; types of debt are distinguished by the source of funding and maturity (due date) of the obligation, e.g., short-term and long-term debt | Extraordinary income | Profit from sources other than the company's stated business, e.g., from investments, the sale of machinery at a price above book value, etc. |
| Depreciation | Reduction in the book or market value of an asset ; e.g., annual depreciation of computer hardware | Financial planning | Analysis of the financial situation of a company and forecasting/estimating the company's future financial development, e.g., capital requirement, depending on the actions taken by the company |
| Differentiation | Marketing concept denoting the differences between the features, advantages, and benefits of similar product offerings, i.e., how competing products and services differ from one another | Financing | Obtaining or providing financial resources or capital for a project or business |
| Direct mail | Method of approaching customers by mail (in contrast to advertisements in the print or electronic media); in order to send direct mailings to a targeted group of recipients, the addressees are typically classified and selected in accordance with specific demographic criteria | Fixed assets | Assets comprising durable goods for recurrent, successive, or permanent use |
| Distribution | Planning, implementing, and controlling the transport of products and services from their source to a customer | Franchising | Sales and licensing system in which self-employed franchisees use brand-name, merchandise or services provided by the franchiser. The franchiser determines business policy; the franchisee pays a licence fee |
| | | Gantt chart | Diagram showing the course of a project over time; the sequence and duration of the various project activities are represented as bars |
| | | Going public | See Initial Public Offering |
| | | Gross margin | Surplus amount remaining from sales proceeds or revenues after deduction of the costs directly relating to the product or service offering; often expressed as a percentage of sales revenue |

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| Guaranty | A promise by the guarantor to answer to the creditor for the Debt of another if the debtor defaults; (sometimes spelled guarantee, which is the more universal term both for the act of giving a security and for something given or existing as a security) | Licence fee | Amount of money charged in exchange for a licence |
| Hard money | Capital that must earn a return, e.g., venture capital | Liquidation | Sale of Assets of the company, followed by repayment of Debt and dismantling of the company |
| Hurdle rate | Minimum return (internal rate of return) that must be earned so that an investment is attractive (venture capitalists typically expect 30-40%) | Liquidity | Ability to meet payment obligations when they fall due, e.g., by converting Assets to cash or cash equivalents |
| Income or earnings target | Budgeted expenditure and projected proceeds within a defined period (usually 1 year); difference = profit (loss) | Loan covenants | Conditions, put on the extention of a loan, such as maximum leverage, minimum earnings margins, minimum liquidity. When a covenant is broken, the bank can call the loan. |
| Income statement | Also called a profit and loss statement; presents the expenditures and receipts (both gross) within a defined period (usually a year) | Long-term debt | Debts that do not have to be repaid within a business year (mortgages , multi-year loans) |
| Informal investor | In the context of a start-up : a wealthy individual who provides venture capital ; non-professional venture capitalist | Make or buy | Decision whether to produce a product or service in one's own company (make) or to purchase it from others (buy) |
| Initial Public Offering | Also referred to as IPO; first occasion on which shares in a company are registered ("listed") on a stock exchange and publicly offered for sale, i.e., the public at large is given the opportunity to invest in the company | Margin | Difference between sales price and total production cost (in manufacturing) or cost of sales (in trading) |
| Internal auditing | Function in a company that reviews financial statements (Balance sheets , profit & loss statements, etc.) to determine whether they conform with the accounts prepared by Bookkeeping , whether accounting and Bookkeeping are performed satisfactorily, and whether the financial statements are in conformity with the relevant standards and regulations | Market analysis | Analysis of supply (or "purchasing") and sales markets with the aim of determining whether and how a given market accepts a product |
| Internal rate of return | Also referred to as IRR; discount rate at which the present value of the future Cash flows of an investment equal the cost of the investment | Market penetration | Percentage of the number of customers in the target market that use your product or service |
| IPO | See Initial Public Offering | Marketing | Canvassing of markets to initiate and complete (exchange) transactions that satisfy the buyers' needs; in many cases, a company function (the Marketing Department), often also a company philosophy that orients a company's activities systematically to the requirements of the market |
| IRR | See Internal rate of return | Mezzanine | Funding sought or obtained mid-way in the development of a new company; commonly refers to the last round of financing before an Initial Public Offering |
| Leasing | A type of rental contract for usage of equipment, tools, and real estate in which the lessor remains the owner, but grants the lessee the right to use them in return for rental payments | Mortgage | Debt instrument giving a creditor a legal right to or interest in the debtor's property as security for the repayment of a loan, e.g., given to a bank by a borrower; (having a legal interest in another's property is also referred to as holding a lien on the property) |
| Leverage | Degree of a firm's indebtedness, usually expressed as the ratio of Debt to equity in a firm's capital structure | Net income | Profit after deduction of all expenses and taxes |
| Liability | Description of the sources of capital and the associated repayment obligations of a company | Nominal case | Assumption of the most likely business scenario to the best of one's knowledge ("normal case"); also often referred to as the "base case" |
| Licence | Contractual authorization to make or produce a patented product or service, usually in exchange for a licence fee | Normal case | See Nominal case |
| | | Operating result | Profit from the ordinary business activity of the company = profit minus extraordinary income |

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| Patent | Legal protection of intellectual property; protection can be obtained not only for products, but also for processes; in the latter case, the products produced with the process are also protected from unauthorized imitation by the patent; a company can exploit a patent itself or licence it to a third party | Skimming | Pricing strategy in which price is initially set at a high level to obtain a high profit; is mainly used for new products or services for which there are few alternatives for the customer (typically contrasted with a “penetration” pricing strategy) |
| Payback period | Time elapsed from an investment is made until all negative Cash flows relating to an investment are compensated for by positive Cash flows | Small and medium-sized businesses | Class of companies with up to about 100 employees |
| Penetration strategy | Strategy aimed at achieving a defined market share referred to as the “target penetration” level, e.g., by introducing a new product at a low price (contrast with “skimming” strategy) | Soft money | Capital provided without obligation to repay it with interest; usually from family and friends, the government, and charitable foundations |
| Positioning | Concept from Marketing ; refers to where and how a product or a company is or should be placed from the customer’s perspective, e.g., with respect to various Customer segments or in comparison with competitors | Start-up | Phase immediately after the founding of a company, often also refers to a growth company (“a start-up”); the start-up phase concludes with an Initial Public Offering or with the sale of the company |
| Post-money valuation | Value of a company after a new round of financing | Start-up phase | See Early stage |
| Pre-money valuation | Value of a company before a new round of financing | Substitute | Dissimilar products or services that meet the same customer requirement or need |
| Present Value | Value today of a future payment or stream of payments, discounted at an appropriate discount rate | Trademark | Protected name, symbol, or combinations thereof referring to a protectible product, service, or business (monopoly usage) |
| Profit mechanism | System whereby a company earns its profits; examples: buying and selling by a trading company; franchising by a fast-food company | Unique selling proposition | Also referred to as USP; concept from Marketing denoting the winning sales argument or the special quality of the product or service that is perceived by customers as offering more Customer value than competing products |
| Profitability | Earnings of a company in relation to sales revenue or to capital employed | USP | See Unique selling proposition |
| Promotion | Materials and activities intended to communicate the value of a product or service to customers to induce them to buy it | Velocity | Speed at which the Business plan is implemented: “high velocity” gives a new product or business an advantage over competitors |
| Rollover credit | Medium-to-long-term unsecured loan for which the interest rate charged is adjusted to the prevailing rate at regular intervals | Venture capital | Funding from investors for the financing of new, fast-growing companies; also referred to as risk capital |
| Rounds of financing | Steps or stages a company goes through to obtain outside capital | Venture capital fund | Professionally managed funds from which venture capitalists finance their investments |
| Sales channel | There are various forms: direct sales, retailing, agency sales, franchising , wholesalers | Win-win situation | Circumstance in which all parties or companies gain or obtain a fairly distributed benefit |
| Sales revenue | All money (earnings, proceeds) that a company generates from the sale of products or services | Worst case | Business scenario based on the assumption that the majority of events affecting the targeted result will be unfavorable |
| Seed money | Funds to support a start-up early in its existence (seed phase) | | |
| Seed phase | First stage of development of a company, usually before its legal founding, in which the business idea is developed | | |
| Sensitivity analysis | Description of the effects of possible changes in revenues and costs on the overall profitability of a project or a company | | |

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