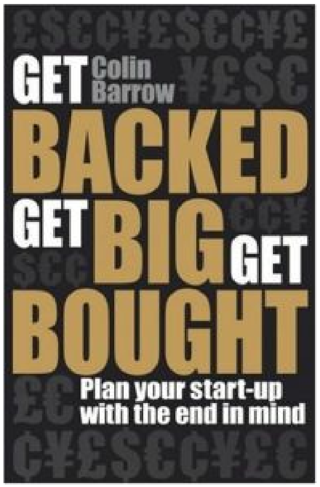

Book Get Backed, Get Big, Get Bought

Plan your start-up with the end in mind

Colin Barrow
Capstone, 2009

Recommendation

Entrepreneurship expert Colin Barrow promises that selling your company is the path to big bucks. The problem is that first you have to start a business and make it successful. Barrow details all the ins and outs of this lucrative practice, from writing your business plan and securing funding to expanding your company and preparing an "exit strategy." He tailors his information to businesses in the U.K., but most of the principles apply universally. Thus, *BooksInShort* recommends Barrow's practical guide as informative, encouraging reading for any entrepreneur with the next great business idea. Heeding his sound advice could help you follow in the footsteps of Bebo founders Michael and Xochi Birch, who in 2008 sold their popular networking site to AOL for £417 million.

Take-Aways

- To create a start-up that will make you rich, begin with the right business formula.
- Follow this "magic recipe": "Value = Problem x Scalability x Money x Barrier to Entry."
- Plan your new enterprise so it will solve a large-scale customer problem in a way that competitors will not be able to match.
- Develop a compelling, research-based business plan to secure start-up funding.
- Make your company's growth a goal from the outset. Your business must become big before you can sell it for a big profit.
- To gain a larger market share, consider going global or buying out the competition.
- Begin planning your "exit strategy" as early as possible, so you'll be ready to take advantage of good opportunities to sell.
- Prepare a compelling "sales memorandum" to market to potential buyers.
- You can lose money by selling your business during a recession. If you can, wait for an upswing to put it on the market.
- In the final analysis, the value of your business is whatever you can negotiate for it.

Summary

"Get Backed"

Most people who start new businesses want to become rich, yet few achieve that goal. Often, those who end up squeaking by lack this "magic formula" for success: "Value = Problem x Scalability x Money x Barrier to Entry." Translation: The value of your start-up is a product of the size and importance of the customer problems it solves, the scalability of its business model, the amount of funds you put into it and the difficulty competitors will have in copying you. Here is how this guiding formula works in the real world:

- **Recognizing a problem** – Tim Waterstone decided to open a new kind of bookstore in the U.K. that targeted three major customer problems. First, he saw that book buyers required extended store hours so they could shop after work. Second, he recognized the need for better merchandising, so he adapted a model from a U.S. bookstore, sprinkling catchy titles throughout the shop. Third, he met the need for knowledgeable staff by seeking "literate young graduates" as employees.
- **Determining scale** – Waterstone had enough home equity to secure funding to open a single bookshop. But his business vision called for a chain of 100 stores. He understood that "big problems require big solutions."
- **Finding the funds** – Next, Waterstone needed substantial financing to turn his ambitious scheme for a bookstore chain into a reality. "The trick was to find a

way of raising enough money to prove the concept, while leaving the door open to raising more once success was in sight." He secured the funds by writing an in-depth business plan and by diligently rounding up backers. He opened the first Waterstone's within three months.
- **Warding off the competition** – Waterstone did not want competitors to copy his business formula, so he devised various barriers to entry. He kept his stores open until midnight and, in some cases, on Sundays. Plus, he paid bonuses to his sales clerks. Competitors could not match these tactics, and Waterstone's recipe paid off. About 10 years after he launched his start-up, he sold it for £50 million.

> "The formula doesn't produce a single numeric answer...[its] sole purpose is to make sure you set off on the right track from the outset."

Entrepreneurs are not all geniuses, though many are visionaries. The most successful, like Tim Waterstone, are the first to detect "latent demand" for a product or service. This ability stems from a vast, insightful knowledge of who their target customers are, what those customers want now and what they will want in the future. Consider your own business idea. Does it offer a solution to an important customer problem? The larger the issue, the more profitable your start-up can become. Focus on "customer need" to develop well-defined "marketing missions" that serve large markets or markets with the potential to grow. Provide tangible benefits to your customers on one of three paths: "low-cost strategies," "differentiation" or narrow market focus. Understand the market forces that will affect your business entry. According to competitive strategy expert Michael Porter, these are "threat of substitution, threat of new entrants, supplier power, buyer power" and "industry competition."

> "Neither does the formula give you 'the answer to everything.' Launching the right business is an essential first step to wealth creation, but…a business plan has to be written, money raised, markets entered, and management teams built and motivated. The business has to be sold, wholly or partially, and the money banked."

Securing start-up capital requires a sound business plan based on solid research. Do your homework so you appear knowledgeable to venture capitalists, whose own research "may be dated and general." For example, say you want to launch a hotel-supply firm. Venture capitalists will likely have broad industry data, such as hotel occupancy rates and room rates. However, they probably won't have data on how much hotels spend per night on bathroom products, which companies supply such products, what the profit margins are, whether customers are satisfied with the products and what substitutes they would prefer. Spark investors' interest by supplying specific, relevant information.

> "Finance can be the defining difference between creating big value and little or no value."

Valuable research tools and sources depend on your industry, but may include your chamber of commerce and a variety of websites, such as Google Trends. Also consider doing your own field research. Ask people about their product preferences. If possible, test-market your product by selling it in a defined region. Your business plan will evolve from your findings. Ensure that it highlights the numerous benefits your business idea offers to customers and contains these elements:

- **"Cover and table of contents"** – On the cover, include the name of the start-up, the date you created the plan, your name and your contact information.
- **"Executive summary"** – Write a concise, lively summary of your plan. This is the most important section of your report. Its purpose: to motivate investors to read the remainder of your plan. Keep it to a maximum of two pages; one is best.
- **"Marketing"** – Provide information on your suggested product or service, as well as prices, target customers, competitors and potential sales strategies.
- **"Operations"** – Describe "processes such as manufacture, assembly, purchasing, stock holding, delivery/fulfillment and website."
- **"Financial projections"** – Predict financing needs and revenue for the first 12 to 18 months. Include a break-even date and the "scope of the profit opportunity."
- **"Risk assessment"** – Offer viable solutions for any business risks you foresee. Investors worry about this issue, so address it as comprehensively as possible.
- **"Exit strategy"** – Explain how your financial backers will score big when you sell the start-up. Include information about possible acquisition and the prices at which comparable firms traded publicly on the stock market.
- **"Premises"** – List the "space and equipment" you will require.
- **"People"** – Specify your relevant skills and abilities, then outline your staffing needs.
- **"Administrative matters"** – Address bookkeeping, accounting, insurance, and so on.
- **"Milestone timetable"** – Set deadlines for the tasks you must complete to be ready to sell your product or service.
- **"Appendices"** – Attach market studies and other "bulky" materials at the end of the plan.

> "The fundamental question is, of course, what are investors looking for? Unsurprisingly, they are using something like the magic formula."

Think of debt and equity capital as the "lubricant" your company requires to launch – and later, to expand. Equity, or "owner's capital," encompasses "private equity" from angel investors, venture capitalists, corporate ventures, and the like, as well as "public capital," or share issues on the stock market. This type of funding doesn't represent a risk to the business. If the start-up doesn't turn a profit, the shareholders just don't receive dividends. By contrast, providers of debt capital, like banks, charge interest payments on loans no matter how poorly your business performs. To meet their financing needs, many start-ups use a combination of equity and debt funding.

"Get Big"

Your new business won't make you rich unless it becomes big. Whoever buys your start-up will propose a payout based on a multiple of your profits, so you want large earnings, and that generally means establishing a large business. Companies that dominate their markets – especially firms with more than 50% market share – are more profitable than their competitors. Plus, with a few exceptions, "size means safety." Therefore, expanding your business and increasing its market share will make it more valuable to future buyers.

> "Profitability tends to be linked very closely with size in the market."

To boost sales and market share, segment your market so you can serve a variety of customers with different needs. Then, "milk your customer base." Keep your customers satisfied so they will tell their friends about you. If you lose clients, find out why, then use that information to hold on to more business. Strategize to "convert non-users" of your product or service into new customers. Since all products have varying life cycles, you may need to develop new products to make up for those that are on the decline. Or, alternatively, relaunch your offerings by positioning them differently or changing their marketing. To expand, consider going global or buying out the competition. However, buying a competitor has risks, and valuing a business is not easy. Be careful that you do not assume "hidden liabilities," such as tax debts or unpaid wages, when you make an acquisition.

> "Small businesses are worth disproportionately less than bigger ones when sold."

While improving your earnings and market share, control your costs and debts. Understand the important figures that indicate your commercial health, particularly the "six measures of profitability": "gross profit, operating profit, net profit before tax, net profit after tax, return on capital employed (ROCE) and return on shareholders' investment (ROSI)." To secure better margins, increase your prices. Reduce taxes by consulting an accountant and filing all eligible business expenses. Carefully manage your company's working capital. Once you grow large enough, you can hire a finance director to handle these tasks for you.

> "As sales rise, costs often escalate as well. Apparently healthy headline sales and profit figures can disguise serious problems."

Often, businesses that have good numbers also have superior management. As the start-up's founder and guiding light, you plan its strategic direction. Your strategy can turn your company into a cash cow – or drive it out of business. Since your goal is to expand your enterprise, hiring is one of your primary responsibilities. Your hiring decisions affect not only your number of employees but also your sales. Indeed, statistics show that companies with 100 to 499 employees "produce three times the sales per head of the smallest businesses." So get growing!

"Get Bought"

After you've found backing, assembled the right team and built a strong market presence for your business, you'll likely be ready to sell. Handle this stage properly so you receive the payoff you deserve. Your company's ultimate value depends on what someone else will pay for it. In that sense, business valuation is hypothetical. But various measures may help you determine how others might assess your company's worth. The price/earnings (P/E) ratio is the most prevalent measure. Many business brokers who sell private firms use a modified version of this method. Venture capitalists favor the discounted cash flow (DCF) technique, which derives from the reasoning that money on hand is worth more than money that will arrive in the future. Certain market sectors rely on specialized metrics for business valuation. For example, restaurant chains often see number of outlets as an indication of value.

> "Most of the potential to add value to a growing business lies in shaping its future competitive strategy."

Begin planning your exit strategy as early as possible, so you'll be ready to take advantage of good opportunities to sell. Try to ensure that the three years leading up to a sale speak favorably for your business. That means high, stable profit margins and sales figures that follow a vertical path. Write a strong business plan that explains your strategies to maintain your upward sales and profit trends. Such a plan can be valuable during your negotiations with a potential buyer. Hire an outside auditing company to go over your books "to avoid horrors being uncovered in the due diligence process."

> "Some entrepreneurs begin preparations for exit from well before the first day's trading."

Prepare a compelling "sales memorandum" to market to potential buyers. Provide all the financial and operational information a prospective buyer may want to see. Make the business look as attractive as possible in this document. Do not include confidential information, such as a listing of your customers. Reserve such data for serious buyers, not just prospects.

> "You will on average speak to 20 prospects before you conclude a deal."

In selling your business, timing is everything. Don't expect to get top dollar for your company during a recession. If you can, wait for an upswing to put your business on the sales block. The health of the stock market is an excellent indicator of the best time to sell. Keep an eye on the business cycle, which reflects "the collective behavior of billions of people." Try to "sell at the peak."

> "Ultimately, you won't know what your business is worth until you sit down around a table with potential buyers and hammer out a deal."

What types of buyers will your business attract? Often, private firms acquire other private companies. Management buy-ins are also common. In this type of purchase, a "capital provider," such as a venture capitalist, "backs an entrepreneur to buy into a company and effectively take it over." Management buyouts occur when a business sells to its own management team. They are popular with venture capitalists. Buy-in management buyouts, or BIMBOs, take place when a company's leadership links up with "a new incoming managing director backed by a venture capital provider" to make the purchase. Or, if your business is a family firm, your best prospects may be your own relatives. To get the best deal possible, consider consulting an expert, such as a corporate finance adviser. Specialists, though costly, can provide valuable advice on finding potential buyers, negotiating a selling price and other crucial steps of the sale.

About the Author

Colin Barrow teaches entrepreneurship at numerous business schools and has published books and other publications on the topic.
