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 1 1/2 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.

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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 a 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 a 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?

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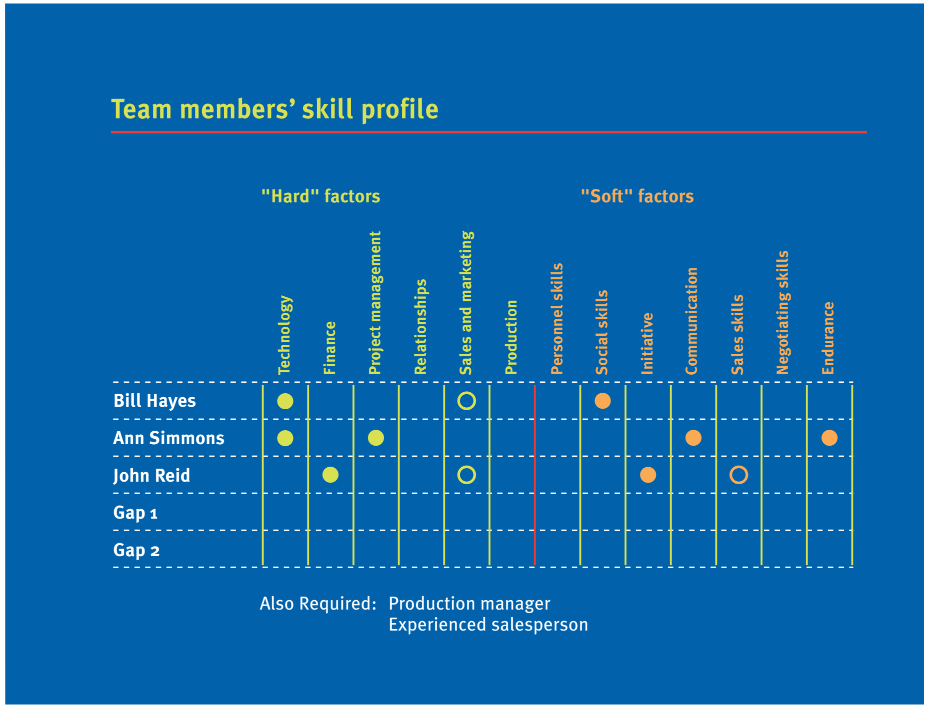
trying to get customers enthusiastic about it. Someone who lacks the social skills to help colleagues through the uncertainties of the start-up phase may later have problems managing a larger business.

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 have 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

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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

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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.

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.

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.

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 for example in the following cases be appropriate:

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%

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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.

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 solutions. 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	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.

Typical business system

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.

CityScape business system

Organizations exist to enable ordinary people to do extra-ordinary things.

Ted Levitt
Editor, Harvard Business Review

Part 3

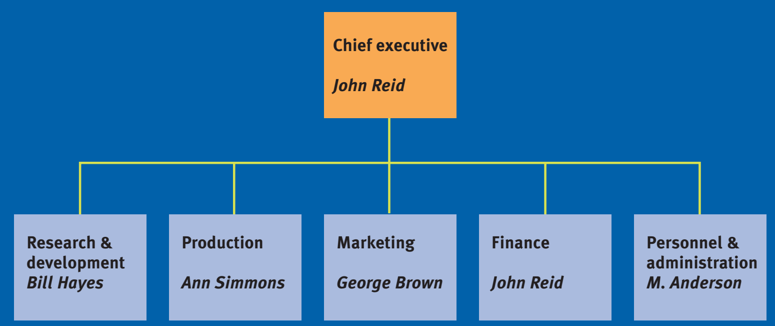
ORGANIZATION

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-

Simple organization for start-up



Part 3

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 m² per year
The Netherlands	175–250
The Randstad conurbation	200–350
Amsterdam	225–500

Space required	m² 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 m² 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

Part 3

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.

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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?

Part 3

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 that you have thought potential investors 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.

Part 3

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

William A. Sahlmann

Part 3

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.

Part 3

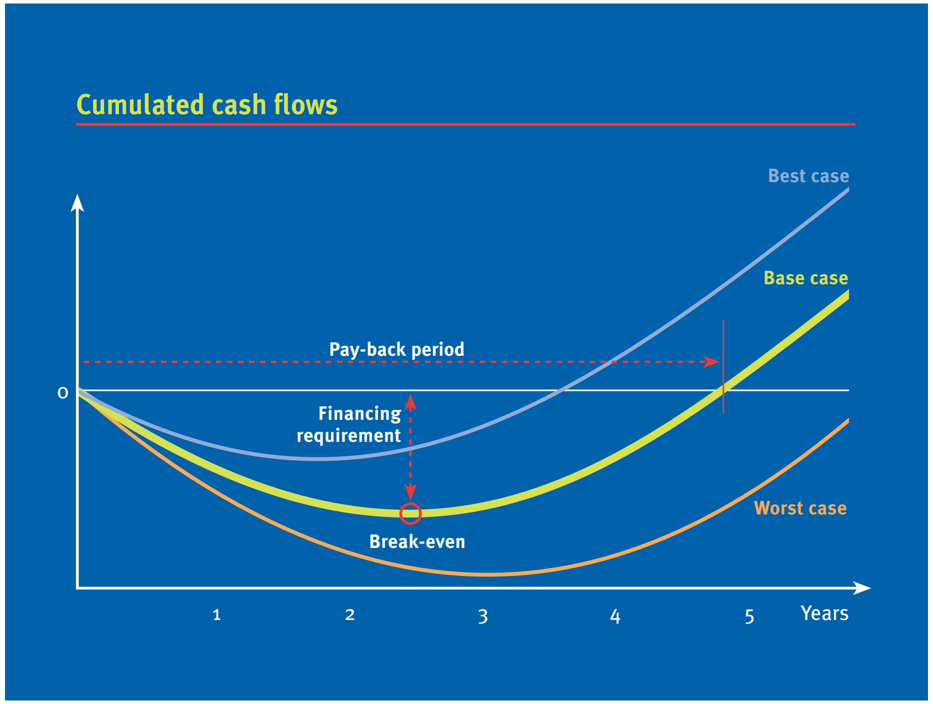
Venture capitalists can take a lot of bad news, but they hate surprises.

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

Part 3

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.

Part 3

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

Brian Wood

Part 3

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.

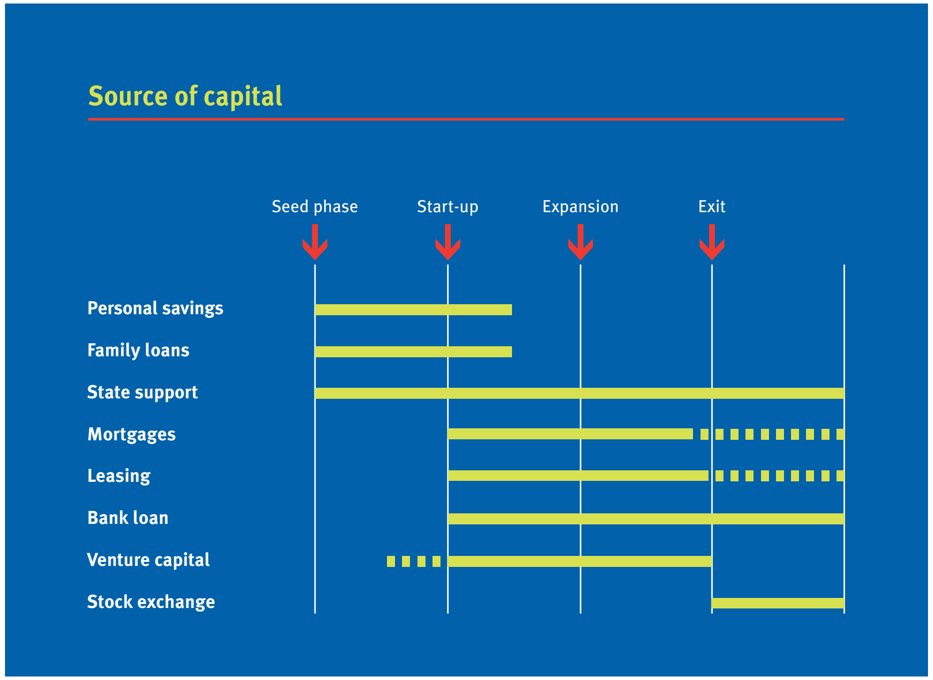
The minimum requirements for the financial planning in the business plan are:

- 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 need 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 has 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 Nederlands 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	100,0	100,0	100,0	100,0	100,0	100,0	100,0
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
Reserves and 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 (%)

	Foodstuffs	Metal	Chemical products	Retail	Wholesalers	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
Reserves 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 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
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

Part 3

Part 3

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?

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

Somerset Maugham

Part 3

Part 3