

Creating a Business Plan

Why Write A Plan?

- **“Business Plan” and “business planning” are fuzzy terms.** They mean different things to different people:
 - A business plan for a new company not yet started (a “startup”).
 - A plan for an existing company, seeking to grow.
 - A plan for a group within a larger company, such as a division or department.
 - A product plan, either for a new product or for an existing product.
 - Within each of these categories, there are large variations in the content of a plan, depending upon the purpose:
 - **To guide management** in running the business: emphasize measurable goals.
 - **To raise money** (equity or debt) or to sell the business: emphasize selling points.
 - Miscellaneous other reasons: to comply with regulations, define job duties, etc.
 - **Entrepreneurial Planning** is all about starting and running a new business. Starting a new business is similar in many ways to starting a new group within a larger company. Or to creating and launching a new product for an existing company. But a stand-alone new business has unique characteristics. Plans include a company description. Raising money usually is a key objective. Such plans tend to be promotional in nature.
 - **Business plans for new ventures are management tools.** Effective plans:
 - Help entrepreneurs focus ideas and convert them into realistic courses of action.
 - Create a specific, defined path for management to follow in the early stages.
 - Identify targets for performance measurement (or “milestones”).
 - Provide a persuasive basis for attracting equity and debt financing, or people.
 - Entrepreneurs often find that raising equity money for their startup venture is one of the major obstacles to success. To raise capital from angel investors or from professional venture capitalists, you must have a great business plan.
 - **Professional venture capital investors see a huge number of business plans** from entrepreneurs seeking to raise money. At JPMorgan & Co., we received over 4,000 business plans every year. We invested only in about 1% of the incoming situations. JPM’s “deal flow” versus the rate of investment is typical for venture capital investors. Not many startups can attract venture capital investment -- and probably should plan to find the needed money somewhere else.
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- o Venture investors think they are busy people. Instead of trying to find a reason to pursue a new investment opportunity, most VCs *try to find a reason to kill it* ASAP:

Annual Deal Flow at JPMorgan Attention Span	Number of Plans	Percent of Plans
Read 3-Page Executive Summary	4,000	100%
Read Full Business Plan	1,200	30%
Call Sponsors, Ask Simple Questions	600	15%
Visit Management Once	320	8%
Intensive Due Diligence, Research	160	4%
Make Offer, Negotiate Price & Terms	80	2%
Close Deal, Make the Investment	40	1%

- o A professional investor's decision to pursue a proposed new opportunity will turn on the quality of the business plan and the accompanying materials. There is no chance whatsoever of raising the needed financing without a business plan. Even with a plan, the content and packaging must be excellent. Concise, hard-hitting, comprehensive.
- o The business plan is management's first, best, and probably only chance to capture the attention of investors. Investors need assurance that management has thought about its corporate goals, management team, products, strategies, competition, and the need for capital. Investors want to know that the sponsors have considered weaknesses as well as strengths, problems as well as opportunities.
- o Many businesses only write a plan when they must, for an external audience such as a lender or an outside investor. "I'm too busy running the business." Big mistake.

"Failure to plan is planning to fail."

- o **Contrary to myth, business plans do not generate financing.** Although financing proposals require a business plan, nobody invests in a business plan. Investors use the document to understand ideas and to gather information. **Investors invest in people and in their perceived ability to implement the plan, not in the plan per se.**
- o The three most important considerations for professional investors in financing a new venture are (1) people, (2) people, and (3) people. More about this later.

- Raising money from professional venture capitalists is only one possible source of finance for your business venture. **Most business startups are not even candidates for professional venture capital financing.** VC's invest only when there is a rare combination of product and market opportunities, coupled with *proven* management.
 - In the year 2000, venture capital funds invested in a record number of companies, roughly 6,000 of them. In the same year, about one million new businesses were incorporated and started up. Note the percentage that received VC financing? Less than 1/100th of one percent!
 - **The most common source (2/3) of equity financing for new ventures is the entrepreneur's own savings** and personal ability to borrow money.
 - The entrepreneur's "friends & family" finance about 10% of startups.
 - Another source is "angels", who are wealthy individuals who occasionally invest a small part of their assets in startup companies. Angels typically invest \$100,000 to \$250,000 in local, early stage ventures.
 - Friends & family, plus Angels finance **20 times** more startups than professional VC's.
 - **But Avoid friends & family if you can.** Startup businesses are risky investments for everyone involved. Many new ventures will fail, and everyone will lose their time and money. Entrepreneurs who finance their startups with money from friends & family risk losing their friends, family and their business -- all at the same time! Not much fun.
 - Some angels are an excellent source of financing. Others are not.
 - **Handle angel financing with extreme caution.**
 - Check their references, do your homework on the people in the same depth that you would -- if you were going to loan them the family heirlooms.
 - Never spend angel money without first doing proper legal contracts.
 - Never spend money that someone has promised to you but has not yet delivered. Investment commitments have a nasty habit of falling through at the last moment.
 - Take the potential angels out to dinner, have a beer. Make sure you like them as people and that you and they seem compatible.
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Creating A Business Plan

The Plan

- **The business plan should reflect the nature of the specific business**, its industry, its stage of development (R&D stage vs. startup, vs. expansion stage.) The plan will reflect the physical, human and financial resources available to the entrepreneur.
 - For this class, **most of our plans will be for startups**. Most such plans will be for business concepts that, if they work, could result in the company growing to a large size -- say, 100+ employees or \$20 million or more in annual sales. (The vast majority of startups are businesses that plan to stay small, even if they succeed.)
 - **Most of our plans will target potential investors**. Senior lawyers call a business plan aimed at equity investors, "a Private Placement Memo". Junior lawyers who must proofread the document call it, "the Book".
 - The text of a private placement memo is 25-30 pages long, excluding attachments. The Book must be crisp and easy to read. It must persuade investors to want to learn more about the Company and its management. Pick up their phone. Ask questions.
 - **Writing an effective Book is time-consuming and not easy**. You will need the active participation of your whole team. Your team must work together in an organized manner to complete and deliver a good Book within just one school semester of time.
 - **In the real world, most Books are absolutely terrible, awful and ineffective!**
 - After a couple of years of practice (in reading Books), professional investors learn how to kill maybe 1/3 of all proposals within the first two minutes, or less. Investors will kill something like 2/3 of all Books within five minutes or so. Investors will read the whole Book in only a small minority of cases.
 - A large number of publications are on the market, readily available, about "How to Write a Winning Business Plan". It almost seems as if many wannabe entrepreneurs do not bother to do their homework and learn about how to write a plan. Or they read an instructional piece, then ignore what it says! In any case, most real Books are badly conceived, badly written and incomplete. These go straight into the wastebasket.
 - For this course, the sponsors will not launch all of the new business ventures on which we work. Of those that do, not all will succeed. But some will.
 - Whether or not a proposed business venture is a good bet for investors, **the professor intends to ensure that all Books are 100% complete and professional in quality**.
 - The following is an outline of a "standard plan". Many variations of the layout are OK, so long as coverage of the topics is complete. **One of the most common mistakes that entrepreneurs make is a failure to provide comprehensive coverage**.
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Outline of a “Standard” Plan

<u>Cover Page & Disclaimer</u>	<ul style="list-style-type: none">o Including “who to contact” information
<u>Executive Summary</u>	<ul style="list-style-type: none">o 1,400 Words or less, 3-4 pages.
<u>Terms of the Financing</u>	<ul style="list-style-type: none">o Amount of financing neededo Price, key terms and conditions
<u>Company Summary</u>	<ul style="list-style-type: none">o Historyo Ownershipo Location and facilities
<u>Product / Services</u>	<ul style="list-style-type: none">o Product or service descriptiono Features and benefitso Competitive comparisonso Production or other sourcingo Technology & patentso Future products & services
<u>Market Analysis Summary</u>	<ul style="list-style-type: none">o Market segmentationo Industry analysis – size and growth<ul style="list-style-type: none">- Industry participants- Distribution patterns- Competition and buying patterns- Main competitorso Market analysis, size and expected growth
<u>Strategy and Implementation</u>	<ul style="list-style-type: none">o Marketing strategy<ul style="list-style-type: none">- Pricing- Promotiono Sales strategy<ul style="list-style-type: none">- Sales forecasts- Sales programs and techniqueso Costs, services and supporto Milestones
<u>Management Summary</u>	<ul style="list-style-type: none">o Management team, plans to fill gapso Organizational structureo Board of Directorso Personnel plan and philosophy, incentives
<u>Financial Plan</u>	<ul style="list-style-type: none">o Key assumptionso Projected financial statementso Projected cash flows & break-even analysiso Key financial indicators and ratios

Outline of Work Flow

- o What are our products / services -- features and benefits? What is unique?
- o Market: Nature and size, segments, growth rate, special factors.
- o Who are the customers? (Demand) What do they think about our product?
- o Who are the competitors? (Supply) Our comparative advantage is?
- o Production – how do we make our product / service? What does it cost?
- o Sales & Marketing – how do we get customers? Salesforce? Advertising?
- o Devise a Strategy -- comparative strengths and weaknesses, scope, timing.
- o Business “model” -- How do we make money? Volume / Pricing / Costs.
- o Legal, accounting, tax and finance, insurance, administrative support needs.
- o Technical -- patents, licenses, other.

Personnel Plan

- o Management skills required -- versus skills already in hand. Fill the gaps?
- o Who, how many, job duties, when, where do we get them?
- o Compensation, stock incentives, costs, fringe benefits (health care, etc.)

Financial Plan

- o Base Case (Main focus); Upside/downside cases.
- o How much money do we need? Now versus later.
- o Identify sources of capital -- founders, friends & family, angels, VC firms
- o Exit for investors: IPO, sell out to strategic buyer, buyback?

Equity Valuation

- o Comparable companies -- research, Bloomberg, Yahoo
- o Valuation -- “trading multiple” model, VC method.

Deal Structure

- o Articles of Incorporation, By-Laws, Shareholders Agreement, etc.
- o Negotiate initial equity (Founders, other investors); incentive stock option plan.
- o Structure terms of the financing offer to investors.

Write Business Proposal

- o Cover Page & Disclaimer.
- o Summary (1,400 words or less) ← Write this first!
- o Main Text. (20-25 pages.) Edit and re-edit for reading ease.
- o Financial statements and financial projections.
- o Shareholders list, management résumés, contracts, other appendices, pictures.

Mail Proposal to Target Investors

Practice and Deliver Oral Presentation

Venture Investor's "Dream Deal"

Mission

- Build a highly profitable and industry-dominant company.
- Go public or merge within 4-7 years, at a high price / earnings multiple.

Complete Management Team

- Led by industry superstar.
- Possess proven entrepreneurial, general management and P&L experience.
- Includes leading innovator or an experienced head of technology marketing.
- Complementary, diverse and compatible skills.
- Reputation for complete honesty and high integrity.

Proprietary Product

- Has significant competitive lead and "unfair" advantages.
- Has product or service with high valued-added properties, with early user payback.
- Has or can gain exclusive contractual or legal rights

Large and Rapidly Growing Market

- Will accommodate at least one \$50 million player within five years.
- Market already has sales of \$100 million or more, growing at 25%+ per year.
- Has no dominant competitor now.
- Clearly identified customers and distribution channels.
- Has forgiving and rewarding economics:
 - Gross margins of 40%-50%, or more
 - 10% or more net income/sales
 - Early positive cashflow and break-even on modest volume of sales.

Deal Valuation and IRR

- Has a digestible, first-round equity capital need (\$2 million to \$10 million).
 - Able to return ten times original investment in five years @ P/E of 25 or more.
 - Has possible additional rounds of equity financing -- at a substantial markup.
 - Has anti-dilution protection and IPO subscription rights.
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VENTURE CRITERIA	Highest Potential	Lowest Potential
<u>Industry & Market</u>	Changes way people live and work	Incremental improvement only
Market	Market driven; identified; recurring	Unfocused; one-time revenue
Customers	Reachable; purchase orders	Loyal to others or unreachable
Value added	High; advance payments	Low; minimal impact on market
Market size	\$100 million to \$1 billion sales	Under \$100 million sales potential
Growth rate	Growing 25%-50% annually, or more	Declining, or growing less than 10%
Market capacity	At or near full capacity	Under-capacity
Market share attainable	20% or more by Year 5; leadership	Less than 5% by Year 5
Cost structure	Low-cost provider; cost advantages	Declining cost; high cost provider
Economics	Highest Potential	Lowest Potential
Time to positive cash flow	Under two years	More than four years
ROI Potential	25% or more, high value	Under 15%, low value
Capital financing requirements	Low to moderate; fundable	Very high; not-fundable
Free cash flow character	Sustainable, 20%+ of sales	Less than 10% of sales
Sales growth	Moderate (25%) to high (50%)	Less than 10% p.a.
Asset intensity	Low – sales / assets \$ ratio	High asset intensity
Working capital	Low, incremental requirements	High requirements
R&D/capital expenditures	Low requirements	High R&D requirements
Gross margin	Over 40%+ / sales and durable	Under 20% of sales
After tax profits	Greater than 10% of sales	Low
Break-even profit & loss	Within 2 years, not creeping out	Over 4 years, creeping out longer
Harvest Issues	Highest Potential	Lowest Potential
Value-added potential	High strategic value to acquirer	Low strategic value
Valuation multiples (vs. comparable firms)	Price/Earnings = 25x or more Price/EBIT = 15x to 18x or more Price/sales = 1.75 to 2.5 or more	Price/Earnings = 15x or less Price/EBIT = 5x or less Price/sales = 0.4x or less
Exit mechanism/strategy	Present/clear options	Undefined, fuzzy; illiquid position
Capital market context	High valuations, good timing	Low valuations, credit crunch

Competitive Advantage	Highest Potential	Lowest Potential
Fixed & variable costs	Lowest; high operating leverage	High costs; low operating leverage
Control over prices, costs	Moderate to strong	Weak control
Control over distribution	Moderate to strong	Weak control or unknown
Barriers to entry	Have/can gain proprietary protection	No proprietary protection or patents
Ease of entry/lead time	Competition slow or napping	Unable to gain lead time edge
Legal or contract advantage	Proprietary or exclusive	None
Pricing attitude	At or near market/nitche leader	Undercut competitor; low prices
Contacts or networks	Well-developed; accessible	Crude, ill-defined, limited
Key personnel	Top talent; an "A" team	Unproved talent or clear "B" players
Management Team	Highest Potential	Lowest Potential
Entrepreneurial team	All-star combination; free agents	Solo entrepreneur, no track record
Industry/technical experience	Top players in their field; track records	Underdeveloped, new to industry
Integrity and honesty	Highest standards; no doubts	Questionable
Intellectual honesty	Know what they don't know	Know everything, no room to learn
Goal and role clarity	Know the vision and their own roles	Confused goals, overlapping roles
Upside vision/risk management	Sets attainable goals; risks limited	Unattainable goals; risks be damned
Fatal flaw	None apparent	One or more visible
Willingness to sacrifice	Will take salary cut, work long hours	Likes status quo
Stress tolerance	Thrives under pressure, bounces back	Cracks under pressure, casts blame
Lifestyle fit	Fits with "normal", preferred lifestyle	Gambling, seeking big money only
Management Attitudes	Highest Potential	Lowest Potential
Service management	Superior customer service concept	Perceived as not very important
Teamwork	Develops & encourages depth/breath	Lone ranger
Timing	Rows with the tide, goes with flow	Resists reality, likes hopeless cause
Technology attitude	Groundbreaker, unique	Many substitutes or competitors
Flexibility	Able to adapt; commit and decommit	Slow, stubborn persistence
Opportunity orientation	Always searching for opportunities	Content, not looking around
Room for error	Forgiving strategy	Unforgiving, rigid strategy

