THE BUSINESS PLAN

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Overview: The Functions of a Business Plan

There are three principal functions of a start-up business plan. Through the preparation of a business plan the founders will be required to analyze the proposed business, evaluate different strategies, define needs, set objectives and map out an operative game plan for the start-up's development. In this sense, the plan operates as a planning tool, helping integrate the founders' business ideas and suggesting a coherent strategy to be adopted.

The business plan will also serve as a company information and sales document for use in raising capital. It will convey a description of the start-up and its proposed business to the prospective financiers. The plan will usually provide venture capitalists with their first impressions of and introduction to the start-up, and will form the basis for subsequent investment discussions.

The business plan also functions as a device to measure and monitor the start-up's performance after receiving financing. In this capacity it informs management not simply where the company is heading, but how much progress has been achieved over time and with what deviations in relation to projections. For the company financiers, early detection of deviations from the plan will indicate needed changes in scheduled financings and help identify emerging problems in time for corrective action.

In its use as a disclosure document for prospective investors, the business plan must convey credibility and accuracy, while simultaneously generating excitement and enthusiasm. The plan should be thorough, professional and realistic. All statements and projections should be substantiated and underlying assumptions identified. The plan should clearly identify risks and areas of uncertainty, as they exist in all start-ups; a reluctance to recognize or discuss such matters will only detract from credibility.

The plan should be concise (thirty to fifty pages is almost always sufficient), easy to read and comprehend, and well focused on the major issues. Aside from the underlying merits of the business or product concept, the business plan will convey a measure of its authors and their organization, thoroughness, analytical skills, perceptiveness, realism and direction. In addition, the start-up's management should be aware that, as part of a venture capital investment, it is common to require a representation and warranty with respect to the accuracy of the plan by both the start-up company and its key officers. A typical provision would read as follows:

"Business Plan. The Business Plan has been prepared in good faith by the Company and does not contain any untrue statement of a material fact nor does it omit to state a material fact necessary to make the statements made therein not misleading, except

that with respect to projections contained in the Business Plan, the Company represents only that such projections were prepared in good faith and that the Company reasonably believes there is a reasonable basis for such projections."

It is advisable to avoid suggesting a precise "cast-in-stone" proposed valuation for the start-up in the plan, providing instead the necessary information and projections with which prospective investors can formulate valuation proposals. Valuation determinations are properly the subject for substantial discussions and negotiations with prospective financiers once interest in the start-up has been generated. There is the risk that an aggressively stated valuation in the business plan will turn off venture investors who may not yet thoroughly understand the basis for the indicated valuation, or who may assume that there is little leeway for negotiation over a pre-determined valuation. A stated valuation which overestimates the venture capital markets receptivity to the start-up may result in no interested venture investors with whom valuation can be negotiated. However, some indication of the desired valuation will almost always be requested by the venture investors as a benchmark to calibrate the risk/return attractiveness of the investment. Diplomatic management of this issue is the key to not overshooting or understating the proper valuation while still in the early phase of attracting interest from venture investors.

An attempt should also be made to avoid either extreme of a sloppy or incomplete plan, or one that appears too slick or "cooked" (i.e., without an indication of gaps, risks or uncertainties). The plan should not be overly long or tedious, nor digress into minute or overly technical detail. Highly confidential or important proprietary information should not be included in the plan, and each plan should contain a legend on its first page indicating that it contains confidential information not intended for dissemination beyond the authorized recipient. To this end a careful log of the number of plan copies and their recipients should be maintained.

Finally, in preparing a business plan for a start-up one should expect that, in light of the multiple purposes to which the plan will be put, the plan will be edited, reworked and revised over time. No plan can form the definitive roadmap for future success. Performance precisely in accordance with the business plan will not be the determinant of either company success or the ease of future financings; rather, the start-up's ability to adapt to new or unforeseen developments, difficulties and opportunities will be the key factor.

The sections that follow discuss the principal areas which should be included within a start-up company's business plan. It should be obvious that each start-up will have its unique attributes and special considerations that will substantially influence the content and focus of its particular plan. In preparing the business plan, it may be helpful to reflect on how a venture capitalist will interpret the information and what would be contained in a brief summary of each salient feature of the plan if such were to be prepared by the venture investor.

Executive Summary

A business plan should begin with an "executive summary" of two to five pages that provides a five minute overview of the key features of the plan.

Its purpose is to enable prospective investors to quickly obtain a sense of what the start-up is about and why they should be interested in it.

The executive summary should be written after preparation of the remainder of the plan and should attempt to distill the essence of each significant plan section. It should include:

1. The company's origins.
2. The product and its underlying technology (including the company's competitive advantage or unique contribution).
3. The potential of the market for the product.
4. The management team and its track record.
5. A five-year summary of key financial forecasts (sales; gross profit margin; net income/loss; earnings per share).
6. The amount of capital investment sought.
7. Other factors particularly important to the success of the venture.

The importance of the summary should not be underestimated--unless it captures the interest of the venture investors and appears convincing, they will not bother to read further. Therefore, before forwarding a business plan to prospective investors it is wise to obtain comments and input from objective sources who will perform a draft review. Attorneys and accountants familiar with the venture financing process, other entrepreneurs who have successfully raised venture capital or any business person whose judgment is well regarded, can all assist in this regard. As part of that review process, particular attention should be focused on the reaction to the executive summary--did the audience grasp the essence of the proposed venture and were they intrigued to learn more. Sufficient time and attention should be devoted to this section of the plan to ensure that it entices the reader to delve further into the start-up--if it does not have that effect, it either needs rewriting or the company's plans need revisions.

Company Description

The purpose of the company description section is to convey a sense of the history and origins of the company, as well as its goals. Relevant information which should be included in this section includes a description of how the concept for the product was originated; who the originators were; why the product concept is considered worthwhile and viable, and what steps have been taken and are intended to be taken to establish a business around the product. It is also useful to include a summary of the company's principal objectives--both its long-term statement of purpose, as well as its specific interim goals that which are considered obtainable with the requested financing.

The company description will, to some extent, anticipate the information to be provided in detail in subsequent sections and therefore should be brief and direct. Some description of the market niche or competitive advantage the founders seek to exploit is essential to convey a sense of the company's origins and destination, but the detailed technological or market evaluation should be reserved for later sections.

Investors will also want to know the organizational, research and development and other

start-up activities that have occurred to date and how they were financed. This information should be set forth as historical commentary on the company's activities.

Management

Management capability is the single most important factor to most venture capitalists. It has become dogma in the industry that the very best product or technology cannot succeed without the management skills necessary to control and operate the business, penetrate the markets and thereafter compete in the marketplace. To venture capitalists, who must rely on a combination of research and third-party advice, personal experience and business judgment to assess the technological viability of a product and scope of the proposed market penetration, the competence and experience of management represents a more visible and subjectively controllable risk factor.

The management section should identify each of the key members of the management team, describe their responsibilities, and set forth the relevant experience and accomplishments of each. Complete resumes, stressing accomplishments and relevant track records, should be included in the Appendix to the plan. The unique abilities of each person and the synergy created by the combination of talent should be the focus of the discussion.

The management discussion should not overstate the abilities of the existing team. If the group lacks particular skills or experience which will be essential to the success of the business, such gaps should be recognized. The company's perception of when such skills will become essential and how it plans to meet the need should also be included. Perhaps as much as current management capability, the venture capitalist is looking for commitment to the business on the part of key personnel and a realistic assessment of what the existing personnel can and cannot accomplish.

The Product

In writing the product description, careful consideration should be given to the venture capitalist's enthusiasm for "products" (defined here to include services) which will meet an unsatisfied or emerging market need or which can out-perform products already available in the market. The product section should describe not only what the product is or will be relative to competitive products, but also why the product has promise to penetrate the existing or developing market.

The product section should communicate a basic understanding of what the product is and how it differs from, and is better than, its competition. Thus, the description of the product should describe its use and function, and what needs it is intended to serve. The distinctive features of the product and the advantages and drawbacks of those features should be addressed. In addition to the particular attributes the product will possess, the cost, quality, reliability and price of the product will all be significant.

If the product is still in the development stage, there should be a detailed discussion of where the project stands and what will be necessary to complete development, including time and cost schedules for achieving both the entire project and various significant interim milestones. The background of the personnel and other relevant data that lend evidence to the viability of the project and the development program should also be highlighted.

Where the development project is technology intensive, a discussion of the nature, status and scope of the underlying technology is necessary in order for the venture capitalist to assess the technological risk inherent in the product's development. This analysis should also discuss the status of competing or alternative technologies and their relative disadvantages (or advantages) as compared to the proposed approach. Equally important, the venture capitalist will want to know where the technology came from, who owns it, how the company acquired rights in it, what its prior applications have been, and, if proprietary to the company, what steps have been taken to protect the technology. Any "blocking" proprietary rights (patents, exclusive licenses, etc.) should also be identified.

Marketing and Sales

The Market. This section should present sufficient information to convince the prospective investor that the start-up well understands the relevant market for its product, as well as establish that the market is large enough to accommodate the company's sales goals. Most venture capitalists do not back mere ideas no matter how brilliant, but rather ideas or products with commercial applications that address or create market needs. It is important to note that the sales forecast will be the factor which most influences the company's financial statements, as all other financial statement components will be driven by the revenue projections.

The general market to be addressed should be identified, described and analyzed. The size of the market, its projected growth, the forces (or needs) driving it and how it is segmented should also be discussed. A common mistake is to ignore the real differences among market segments--whether the relevant market is really a price, quality or even geographical subset of a larger market. In determining the market's characteristics, information can be obtained from available published sources and industry studies, as well as the entrepreneur's evaluations corroborated through his own market research and discussions with customers, distributors and others active in the market. Consideration could also be given to whether commissioning an independent market study will help establish/verify the targeted market and add credibility to the market projections.

Trends and growth potential for the market should be estimated, particularly in an emerging industry. One should attempt to forecast growth for up to five years, particularly in terms of industry trends, new technological developments, evolving customer needs and overlap with complementary markets.

An explanation should be included of the target purchasers of the product, where they are located and what motivates their purchases. Identification should also be included of where the customers fit in the distribution chain, from original equipment manufacturers (OEMs) to end-users. If relevant, an indication of market shares held by major customers or customer groups should be provided. This section should also discuss and rank in importance to the market the significance of price, quality, performance, sales method, service and warranty and any other relevant criteria. It may also be quite useful to obtain possible product reactions from potential customers that can provide evidence of market desire for the product, or indications of need for refinement or revised features with respect to existing competitive products.

Competition

Make a concerted attempt to identify competing products and technology, both those currently existing and those potentially competing in the future. It is amazing to witness entrepreneurs who are so enthralled with their technology that they dismiss the potential for any competition. Avoid this pitfall by examining the potential for competitor entry even if there are currently no direct competitors.

For the competitive review, a thorough assessment should be made of the market share, positioning, strengths and weaknesses of competitive products. Similarly, provide some analysis of the managerial and financial strengths/weaknesses of the companies that produce such products and their recent trends in sales, market share and profitability.

Thoroughly compare your product to competitive products on the dimensions of price, quality, performance, service and other relevant features. A detailed comparative table is often prepared to provide a summary presentation and, if utilized, should be accompanied by an explanation of why the distinctive features of the start-ups product better address the market's needs.

The analysis should include a discussion of whether and to what extent market penetration will be achieved at the expense of, or in conjunction with, the competition. If the proposed product will threaten the existing or expected market share of competitors, thought should also be given to their defensive reactions and how best to counteract them.

Projected Market Penetration

This section should indicate a description, often graphically illustrated with a tabular presentation of the product's estimated market share over a five-year period, expressed in percentages, units and dollars. This estimate should be based on the market size and growth trends, an analysis of the competitive products, and an assessment of the product acceptance and market penetration over time. This will need to be followed by a description of how and why such sales penetration will be accomplished, including a description of intended product pricing, distribution practices, sales policies and customer support, advertising/public relations and product positioning.

Product pricing will, of course, influence both market acceptance as well as profit margins, but must be driven by product positioning in terms of features, quality, prestige, service and support, as well as competitive conditions. It is useful to explain how the pricing strategy evolved and what impact the chosen or alternative strategies will have on market penetration and profit margins. Any significant cost difference with competing products should be justified on the basis of distinctive features. A discussion should be included of the expected price movement over time in the face of competitive pressures and technological innovations, and the expected effect on margins.

The sales and distribution channels should be addressed, including the extent to which the company envisions using its own sales force; to what extent independent sales representatives, agents and distributors will be utilized; and how the two systems will interact. Distinctive features that should be covered include the grant of any exclusive distribution rights; sales commissions and reseller's margins; discount policies; and foreign sales. If the product will require service and after-sales warranty coverage, indicate the importance of these to the customer's purchasing decision and discuss the method

planned to accommodate these needs. Advertising and promotional efforts should also be addressed briefly in the context of bringing the product to the attention of prospective customers, emphasizing any special plans or requirements in this area which merit further elaboration.

In closing the discussion of the marketing section, the co-authors would emphasize that, in their experience, the most common reason for failure of start-ups is poor basic marketing plans. Eventually, a large percentage of start-ups get their technology to work. But far too many introduce "me-too" products, or fail to hit the "strike zone" by stimulating and/or satisfying a major unmet need. It is typically easier and far less costly to take on (and eliminate) technological risk than it is to eliminate market risk. Consequently, the importance of a well-analyzed and sound marketing plan to the credibility of the business plan cannot be overstated.

Manufacturing Operations

For start-ups in the product development stage who are initially seeking funds solely to develop a product, this section should focus on an overview of the intended manufacturing process, including the degree of in-house versus contracted manufacturing; elements affecting production costs; sources of components, raw materials and supplies; anticipated quality and production control systems; and perhaps most importantly, anything unique to the manufacturing process.

This section should be geared to the stage of the company's development and the nature of its product. It may include a description of the proposed manufacturing facility, its proposed location and equipment needs; sources of raw materials and components; labor issues such as special skills required, the role of unions and recruitment concerns; and an overview of the actual fabrication process, both initially and as it will evolve.

Corporate Organization

The amount of discussion on the corporate organization should vary with the size and development stage of the company. For a start-up primarily engaged in early product development, this section should address the current (albeit limited) organizational structure, reporting relationships and management responsibilities; identify existing or projected managerial gaps; and provide an overall sense of the personnel needs and the organization's growth over time.

The wage and salary structure for all employees and any incentive or stock ownership/option programs should be identified and verified as consistent with start-up and industry norms. If the use of consultants, part-time or contract assistance is contemplated, it should also be discussed. Outside professionals, such as law and accountancy firms, who have agreed to act for the start-up, as well as respected individuals who are willing to serve on the Board of Directors, should all be identified as they are positive sources of credibility and support for the venture.

Financial Statements and Projections

The financial forecasts contained in one of the business plan Appendices should include balance sheets, income statements and cost flow projections for five years, with the information presented monthly for the first year and quarterly thereafter. Within the business plan itself there should be a summary of the key aspects of the financial

forecasts. This might include the total cash requirements, when positive cash flow will be obtained and the expected growth in revenues, profit margins and shareholders' equity.

If appropriate, the financial summary can also contain a certain amount of sensitivity analysis, indicating what financial statement impact would result from changes in major assumptions underlying the forecasts. In addition, it is useful to summarize the expected use of the funds to be raised in the current financing.

The most significant aspect of the forecasts will be the underlying assumptions from which the numbers are derived. These assumptions should be discussed at sufficient length to convey an understanding of how they were determined. At a minimum, the logic for determining the following should be included: sales, market share, prices, expenses, accounts payable payments, accounts receivable collections, inventory turnover, margins, taxes, and useful life of equipment.

It is essential to the credibility of the financial forecasts that the assumptions be realistic, logical, attainable and either consistent with industry norms or any deviation explained. In this regard it should also be stated whether best, medium or worst case scenarios have been assumed. Because of the importance of credible financial forecasts, entrepreneurs without much familiarity with financial statements should seek assistance with their preparation from an accountant or other source familiar with the process.

Appendices

The following, where applicable, should be included in an Appendix to the business plan:

1. Financial statement forecasts
2. Resumes of key managers
3. Photographs or drawings of the product
4. A list of professional references
5. Market studies or third party evaluations
6. Patent histories
7. A brief summary of any material contracts
8. Articles in trade journals or general media
9. Charts, graphs or tables which amplify the text of the plan