Define and Validate Your Business Model

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Overview

• Business Models:
  – Definitions
  – Types of business models and their inputs
• Capital Requirements
  – Financing to value creation milestones
• Exercises for you...
What makes a good business?

- Will it work?
- Are materials available?
- Is it scalable?
- Can it be tested cost effectively?

- Who is the customer?
- How many customers?
- Value proposition to the customer?
- Competition?

- Can the management team grow the business?
- Can the team grow with the business?

- How much revenue can you generate?
- What are the costs?
- What are the long term goals?

The Four Steps to the Epiphany

Concept / Seed → Product Develop → Alpha / Beta test → Launch / FCS → Co. build

Product Development Model

Customer Discovery → Customer Validation → Customer Creation → Company Building

Customer Development Model
Customer Discovery Process

Phase 4 - Verify

Phase 3 – Test
Product Concept

Phase 2 – Test
Problem Hypotheses

Phase 1 – State
Hypotheses

Goal of Customer Discovery…
Answers to these questions!

• Have we identified a problem the customer wants solved?
• Does our product solve these customer needs?
• If so, do we have a viable and profitable business model?
• Have we learned enough to go out and sell?
  ✓ Draw a day in the life of a customer
  ✓ Know the org chart of users, buyers, influencers, and channels
Business Model

- How will you make money?
  - Revenues
  - Who are the customers for your product/service?
  - Why do they want it - “Value Proposition”?

- How much will it cost to generate your revenues?
  - Expenses: COGS, CAPEX, and OPEX

- How much revenue can you make and how quickly?
  - Cost of Capital

Definitions: Margins

- Revenue
  - Money coming into the business

- Cost of Goods Sold (COGS)
  - What it costs to make your products

- Gross Margin
  - [Revenue – COGS]
Definitions: Expenses

- Fixed costs
  - Don’t change with time
  - Capital Expenses (CAPEX)
  - Salaries
- Variable costs
  - Change with volume/time
  - Operating Expense (OPEX)
    - COGS
    - Salaries

Definitions: Profitability

- Net Income
  - Revenues minus all expenses
- EBITDA
  - Earnings Before Interest, Tax, Depreciation and Amortization
  - Useful for valuation comparisons
- Cash Burn Rate
  - How much cash you lose each month
Definitions: Pro-Forma Statements

Pro-Forma Statements

• “Best Guess” predictions
• Designed to show the impact of a certain choices

Definitions: J-Curve

Capital required to reach “Cash Flow Break Even”
Revenue Models

- **Unit Sales**: Sell a product or service to customers (wholesale, retail, or direct).
- **Advertising Fees**: Sell opportunities to distribute messages (viewers, readers, listeners, or others).
- **Franchise Fees**: Sell and support a replicable business for others to invest in, grow, and manage.
- **Utility Fees**: Sell goods and services on a per-use basis.
- **Subscription Fees**: Charge a fixed price for providing access to your goods or services.
- **Transaction Fees**: Charge a fee for referring, enabling or executing a transaction.
- **License Fees**: Sell the rights (exclusive or non-exclusive) to use patent- or copyright-protected IP.
Revenue Models for Software

“Standard” – unit sales (up-front license fee) plus maintenance & support subscriptions (e.g., Oracle)

SAAS – license fees, maintenance, & support all on-going subscription fee (e.g., Salesforce.com)

Support – give away product, sell maintenance & support (e.g., Red Hat)

Premium Version – give away base product, sell premium product (e.g., Dropbox)

Add-ons – give away base product, sell add-on products (e.g., Zynga)

Additional Revenue Models for Web

Subscription – monthly fee to gain access to content (e.g., New York Times)

Advertising – give product away, incorporate ads (e.g., Yelp)
  • Can be cost per impression, cost per click, or revenue share per click

Hybrid – base product free but supported by ads, premium product has no ads (e.g., Pandora)

Affiliate Sales – revenue share for delivering customers (e.g., Amazon)
Distribution Models

- OEMs
- System Integrators
- Direct Sales
- Manufacturer’s Representatives
- Resellers
- Multi-tier (Distributors -> Resellers -> Users)
- Retail Stores (can be single or multi-tier)
- Online

Distribution Model Impacts Costs

- OEMs, System Integrators absorb most of the cost of customer acquisition
- A Direct Sales force is expensive, only works for high value sales
- Manufacturer’s Representatives need marketing support
- Resellers/Retailers need substantial marketing support – they are order-takers not sales people
- Online requires substantial web marketing expense
Revenue Model Impacts Expenses

<table>
<thead>
<tr>
<th></th>
<th>Unit Sales</th>
<th>Software</th>
<th>Subscript.</th>
<th>Consult</th>
<th>Licensing</th>
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<tr>
<td><strong>COGS</strong></td>
<td>Materials &amp; Labor</td>
<td>Labor &amp; Servers</td>
<td>Servers</td>
<td>Labor</td>
<td>In-licensing</td>
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<tr>
<td><strong>Sales</strong></td>
<td>Distribution</td>
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<td>Online / Telesales</td>
<td>Direct</td>
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<td><strong>Marketing</strong></td>
<td>Advertising</td>
<td>Advertising</td>
<td>Customer Acquisition</td>
<td>Public Relations</td>
<td>Minimal</td>
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<tr>
<td><strong>Product Develop.</strong></td>
<td>New Products</td>
<td>Maint &amp; New Prod</td>
<td>Content Develop</td>
<td>Limited</td>
<td>Enhanced Products</td>
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<tr>
<td><strong>G&amp;A</strong></td>
<td>HR</td>
<td>HR</td>
<td>Billing</td>
<td>Low</td>
<td>Legal</td>
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Now it’s your turn...

- Cost/unit
- Price/unit
- # units sold/year
- Revenue/yr
- Annual Profit/yr
Stage 2: How much will it cost you?

How much funding do you need?

Look closely at your expenses

- Create an Excel file
- Cut and paste the following expenses...
- Delete the rows you don’t need (that aren’t significant)
- Add time periods across the top
- Start making assumptions...

Sources of Capital

Match source to opportunity

- Owner: 27%
- Bank: 17%
- Trade: 16%
- FFF: 13%
- Debt: 7%
- Angels/VC: 20%

Business Development Financials

Stage 2: Projected Financials

Sources of Capital

Match source to opportunity

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Next Steps: Validating Your Business

Using the exercises in the course book, identify the critical uncertainties around your business and business model (the Customer Discovery process):

1. Rank order the uncertainties.
2. Identify which should be resolved first (in the next 9-12 months). These are your business milestones.
3. List the resources (people, equipment, $) you need to reach those milestones.

Customer Discovery Process

Phase 1 – State Hypotheses
Phase 2 – Test Problem Hypotheses
Phase 3 – Test Product Concept
Phase 4 - Verify
What is the Value of this?

Vinturi Wine Aerator
$89
• $5 Worth of Cast Acrylic
• Helps with reduced wines
• Ruins many wines
• Why is it $89?

The Value is:
Feeling good about giving an expensive gift to the wine lover in your life.

$120M in Sales Annually
My Example:

SmartCaps
3 commercially available oxygen rates

.11 ppm / year
.21 ppm / year
.49 ppm / year

Find the Deep Needs

2,4,6-Trichloroanisole (TCA)
Some Deeper Needs for Wine closures

Alternative to cork
- Doesn’t Leak
- Doesn’t Contaminate
- Allows Oxygen

SELL THE WINE
- How much?
- How Consistent?
- Attractive On-Shelf
- Not Look Cheap
- Change Consumer Perceptions
- Have Customer buy 2nd Bottle!

Thank You

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