Entrepreneurial Action

A step by step approach to starting your own business

Bob Caspe

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A Philosophical and Practical Approach to Small Company Development, Marketing & Survival

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1 Preface

There are three kinds of people:

Those that make things happen, those that watch things happen and those that wonder what has happened[1]*. Our goal is to become members of the first group.*

In some ways, it is my intent to achieve a similar combination in this book as Robert Persig achieved in *Zen and the Art of Motorcycle Repair*; for me it is the combination of a basic philosophy of small business with practical rules for success and some good stories about several small businesses that are currently trying to find their way.

At this moment, I am a full time lecturer at Babson College where I teach a few courses including "Marketing for Entrepreneurs" in the MBA program. Len Schlesinger, our new president, is fond of saying that we teach and live "entrepreneurial thought and action." Around me I do observe a lot of entrepreneurial thought, but frankly, little action. Most of my students are well skilled in the process of entrepreneurial thought which centers on the business plan. But, unfortunately, most of them have never engaged with a real customer, ever asked for a purchase order, or closed a sale.

"It has been observed that during the most recent economic collapse that Israel has none-the-less thrived[2]" as stated in Senor and Singer's article. They continue: "Even in 2008—a year of global economic turmoil—per capita venture investments in Israel were 2.5 times greater than in the United States… and Mark Gerson, an American entrepreneur who has invested in several Israeli start-ups, described it, 'When an Israeli man wants to date a woman, he asks her out that night. When an Israeli entrepreneur has a business idea, he will start it that week. The notion that one should accumulate credentials before launching a venture simply does not exist. This is actually good in business. Too much time can only teach you what can go wrong, not what could be transformative.'" To me their key to success is their willingness to take entrepreneurial action, sometimes without a lot of thought.

As one who has never been formally schooled in business, but did spend 36 years of my life as the president and CEO of various small businesses, I have a wealth of practical information about what works and what does not. Yet, my fundamental beliefs about business center on what my mother taught me over fifty years ago: "Bobby, if you

[1] Gaelic Proverb

[2] The Daily Beast, November 2, 2009 Dan Senor and Saul Singer

don't ask you won't know." I've always believed that direct engagement with customers could and would lead me to opportunities.

When I was twelve, for reasons that I can't recall (or possibly I've repressed), I disassembled my parent's TV and reassembled it with, unfortunately, several parts left over. The TV never functioned again (and my mother either never figured out that it was me or had the good sense to not stifle my curiosity but simply bought another television). The same curiosity that drove me to take apart that TV and pursue an engineering education has driven me to seek out an understanding of how the world and the businesses around me work. My curiosity has served me well in business by leading me to opportunities through the observation of business problems that other people experience.

In my class each semester students come with their business plans that have been carefully authored and retooled over their one or more years on their path to their MBA. Virtually none of those plans are likely to succeed without modification yet virtually all can serve as a first step towards success. The key is simply to use the plan or more precisely the product or service that has been designed as the method by which the student can directly confront potential customers and find a path that is of actual interest to a customer.

I am a strong advocate of small business. The predominance of my experience centers on small business creation and this book is focused upon entrepreneurial action as applied to the creation of small businesses. As stated in a recent SBA report[3]: "…the U.S. profile also shows that:…[small businesses] employed 50.2 percent of the nation's nonfarm private workforce in 2006."

I have structured this book by dividing it into two sections: the first covers many issues that are common to startups, which I call "Entrepreneurship" while the second is focused entirely on "Marketing and Sales" as it relates to small companies. These sections connect in a critical way. Many of the decisions that one makes in a small company are specifically related to optimizing one's likelihood for survival. Thus, marketing concepts in a small company are dictated to a great extent by resource constraints. Marketing programs and business plans are effectively patterned behaviors which are developed in anticipation of patterned responses that are assumed as the result of either study or intuition. I will make the case that in small business this is a dangerous assumption.

[3] SBA Number: 09-15 ADVO

Marketing programs attempt to understand and predict human behavior. I will make the point that this is impossible and the only alternative is to attempt to model the probability distribution of human behavior as a response to a campaign. I will show why this is so terribly difficult for small companies with limited resources.

The second section focuses on marketing because I truly believe that most small businesses fail, not because of deficient products, but rather because of deficient marketing and sales plans. Often the new product is perfectly wonderful, but that it's impossible to figure out a way to get it into the market profitably. Most of us think that "marketing" and "selling" will come naturally to all of us. We believe that, since we're all consumers and we frequently participate in marketing and selling as buyers that we are naturally qualified at being able to handle this as a process. Nothing could be further from the truth.

There is a companion website at http://www.caspegroup.com that goes along with this book. On the website are video interviews of several of the businesses that are used as examples in this book. As well, there are simulators that can be used to hone ones skill in direct marketing.

1.1 My MBA Course "Marketing for Entrepreneurs"

The class will be divided into a number of teams (typically around 10) that will each focus on their own business plan while offering debate and critique of the other nine. In the past, it was the process to use student proposals entirely for the business teams. Unfortunately, many of the proposed businesses are not adequately formed in order to serve as good examples for the course.

Therefore, some of the teams will be executing a process of "search selling" where they will be attempting to find business to business (B2B) opportunities that they can work on for the semester.

Together, we will spend quite a bit of time during the semester reviewing the proposed products or business ideas created and presented by the students along with their derivative marketing strategies. I openly encourage students to abandon what seem to be poorer ideas and move to better ones during the course. All of the three companies that I co-founded abandoned their original business strategies and pursued better ones that were uncovered later on. The most important part of starting a business is simply to start. By being in business, you increase the likelihood that you will both discover and be discovered by opportunities that lie ahead. Often, the business ideas brought to the class are not adequate to build a world-class company, but they are, if tuned somewhat, adequate to start a money-making endeavor. Thus, the courage to begin is the most important attribute necessary for finding eventual success.

Duncan Miller and Brian Hayden were two students in my 2007 class. During the first few weeks of this class, they were able to dream up a dozen different ways to enter the Geothermal Heating and Air Conditioning market, a particular interest of theirs, and by the end of the semester they had selected one of the ideas, formed their company, Heatspring Learning, and earned over $30,000 of gross profit. I will explore their business more later on in this book.

Some students have expressed their disinterest in discussions about channels that were not particularly relevant to their current business model. For example, discussions about retail were not of interest to those focused on B2B models. I want to emphasize that it is important and relevant to study these models for two reasons. First, you don't really know what your next business idea will require. Second and more importantly, as one becomes a student of marketing and small business development, one begins to see that all of these channels have identical problems and similar solutions. Each requires developing methods that motivate both the end-customer and the channel participants to act in ways that benefit the manufacturer or originator of the product or service. In the end, business is defined by leverage. Values must be discovered and used whether talking to a consumer or the president of a company.

A cheesy call to action like "act now and get free shipping" that might compel a consumer while watching an infomercial is in fact no different than suggesting to a business customer during a sales presentation that your production capabilities are limited and signing up now would ensure a more timely delivery. I \ encourage all students to look into each of the B2B and business to consumer (B2C) channel models for these common threads and in that way develop a more basic understanding of how one markets and sells products and services.

In many of the consulting projects that I see, the company starts with a product concept or even a finished prototype. Essentially, the next steps are:

1. Create the Value Propositions (for the end user and resellers) and attempt to quantify the values for each
2. Create an understanding of the "category" in which you are participating in and how that influences your Distribution Strategy.
3. Identify your Customer Base

4. Create a Distribution Strategy
5. Create a Lead Generation Method for your direct target, possibly a reseller, and if necessary, lead generation techniques to be used by your resellers
6. Create a Sales Pitch which is centered around the value proposition for your specific target
7. Create a Financing Strategy
8. Turn the Crank
9. Make sure that there is channel Sell-Through.
10. Buy a Boat – (and invite your professor for a ride)

This course will attempt to give you the tools to create tactical plans for each of these critical steps (except for purchasing a boat).

The majority of time that we spend together in this course is focused on the business plans that are created and tuned by teams formed from class members. The goal of the course is to get the teams to create rational strategies that can effectively launch their businesses. In many cases the emphasis will be on short term strategies that can lead to achieving a positive cash flow as quickly as possible. The reasons will soon become clear.

When one is starting a new business there is a balance needed between keeping your ideas secret so that they are not stolen, versus sharing them so that, through debate, or advocacy, they are enhanced. Many entrepreneurs will ask the recipients of information to sign Non Disclosure Agreements (NDA) to protect their ideas from exploitation or wanton distribution. I leave the issue of deciding whether to divulge your ideas to the class with or without an NDA completely up to each of you independently. If you feel that you require an NDA from every other class member, including me, prior to discussion, it is your responsibility to distribute and get everyone to sign it before you disclose confidential information.

The idea and product that you pursue while in this class may not be your best or last great idea. You will likely gain more through open discussion than you will risk through disclosure without the need for an NDA. I do ask that everyone does make a reasonable effort to act in accordance with the general principle that the business ideas expressed by students within this forum be treated with respect as if an NDA was signed. For those of you who want a template for an NDA, I have attached one as ATTACHMENT A. I am not a lawyer and I do not know or represent if this document is complete or effective.

1.1.1 Associated Prerequisite Readings

This book and the related course refer to several Case Studies which can be obtained independently by the reader and are suggested in order to provide a context for some of the materials. They can be purchased on line from Harvard Business Online, the website of Harvard Business School Publishing. They include:

- TiVo Case Study 9-501-038
- Erox Case Study
- *The Drunkard's Walk: How Randomness Rules Our Lives* by Leonard Mlodinow

In addition, the following are also recommended but not required. They can be found at libraries or viewed online for free.

- Frontline video "Is Wal-Mart good for America."
- WGBH American Experience video "Tupperware."
- Frontline video "The Persuaders."

1.1.2 Podcasts

When editing this book for the second time I decided to add a family of Podcast case studies that track several small startups as ways of illustrating many of the concepts contained within the book. The podcasts are available on http://www.caspegroup.com. They should provide the viewer with a better understanding of entrepreneurs and the challenges that they face. These podcasts track several companies over time. The goal was to avoid revisionist histories that tend to only remember the best decisions and most fortuitous opportunities. By visiting each company approximately once per quarter, we are getting a "behind the curtain" view of entrepreneurship as it unfolds.

Each case is presented in greater detail in the addendum for that case.

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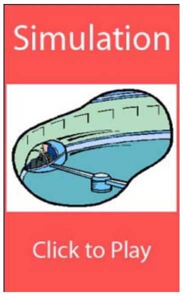
1.1.3 Simulations



I am a great believer in following the data and avoiding intuition when it comes to the creation of rational marketing strategies. The best example of this is when running a direct marketing campaign. The use of your own spreadsheet which calculates metrics on which you base decisions is critical to optimization of the campaign. There are separate companies to help you with different parts of the campaign. The performance of their employees is not visible, but some of the companies will use methods available to them that "cook the numbers" in such ways to encourage you to spend more.

With this in mind, I created a simulation for running a direct marketing campaign. The details are contained within an addendum. You can use the simulator on my website at http://www.caspegroup.com.

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1.2 Acknowledgements

Thanks to the many guest speakers that I've had from whom I have pirated observations and insights and definitely expanded my own understanding of marketing and entrepreneurship. These include: George Adam, David Aronoff, Gary Eichhorn, Frank Mineo, Charley Polachi, and Susan Willard. Thanks as well to many of my students including Brian Hayden, Duncan Miller, Eric Andersen, Rush Hamburten, and others who have challenged my concepts, contributed ideas and, in some cases, examples that I use in this text. Many thanks to my fellow teachers, some of whom, like Candy Brush, Abdul Ali and Michael Mozill have added content and offered editing advice.

This book, my own career, and the enjoyment that I got from it would not have been possible without the endless patience and support from my wonderful wife, Lynn and my two incredible daughters: Emily and Becca who helped me develop my course and edited the text of this book.

1.3 About the Author

Bob Caspe has substantial experience in starting small companies. He co-founded and served as CEO and chairman of three high technology companies within the Boston area:

CDA – A company that specialized in the development of high speed arithmetic processors used in the radar, sonar and medical systems such as CT scanners and MRI systems. CDA also developed end user Nuclear Medicine and PACS systems which were sold directly to hospitals.

Leaf Systems – A company specialized in the development of high quality film scanners and professional quality digital cameras. Leaf also developed newspaper systems used by wire services and newspapers throughout the world.

Sound Vision – A company that developed numerous low cost consumer electronics imaging and audio products that were sold through OEM relationships and directly to consumers through retail and direct marketing channels under the brand name Armchair Electronics.

Bob has direct, hands on experience in developing OEM relationships, retail and consumer direct marketing programs and various B2B endeavors. A detailed resume and a review of his current consulting activities can be found on his company website: http://www.caspegroup.com. He is currently consulting to a number of small companies and serving as full time lecturer at Babson College where he teaches several courses on entrepreneurship.

2 Entrepreneurship

This section of this book primarily deals with what sets apart the problems and behaviors of an entrepreneur who wants to start a new business from someone who works for a large company.

Duncan Miller, cofounder of Heatspring Learning, a geothermal heating and air conditioning consulting firm was asked: “even though you’ve had an extremely difficult and disappointing year, now that you have experienced being an entrepreneur and run your own business, do you believe that you could take a job with a large company some day?” His response was an unequivocal: “no!” My own experience and my observations of other entrepreneurs are identical. Duncan also commented as to “how hard running a small business is in comparison to his expectations.”

Being entrepreneurial in a large company is quite different from starting your own business. It appears that most, if not all, of the case studies and theories are based upon larger companies and there isn’t much help for those who simply want to get started, often from scratch.

The intent of this portion of this book is to provide some fundamental understanding of why it is so different and so difficult in comparison to other business ventures. The goal is to provide a framework of understanding that can lead to decision making that will extend the survival and therefore the likelihood of finding success (however success is defined).

2.1 Introduction to Entrepreneurship

In the 1940s, many movies had similar plots: An orphanage desperately needs money or it will be forced to close. The lead character and friends ponder how to save the orphanage and then someone shouts the line: “I’ve got an idea, let’s put on a show.” The rest of the movie is the pure enjoyment of watching them rebuild the theater, build the sets, rehearse the lines, and prepare for the “big night.”

Building a company is exactly the same thing. The process of creating a company from nothing is where the fun is and the entrepreneur’s job is to shout the line, recruit the cast and crew and lead the production effort. The marketing plan for a company is the plot line for the movie. It’s got to hang together in order for it to work out. But don’t forget: the fun is in the making, not in the counting of the money.

Most entrepreneurs have had successes and failures and would not trade a moment of the experience for anything.

There is a fundamental misconception shared by many about small company planning. Startups are generally resource constrained, where the available resources include capital, experience, available labor, customer relationships, reputation, etc. Their destiny is dictated to a great extent by serendipitous or calamitous external forces. Successful strategies must be centered upon creating and using methods for survival and identifying and seizing opportunities that are discovered as opposed to growth.

2.1.1 Are You Building a Company or a Product?

The first edition of this book (in 2006) included the following paragraphs on getting started:

One of the first questions to ask yourself is whether you intend to build a product or a company. There is a difference although you can start building a company by building a single product. Your choice of financing alternatives, the types of people that you might recruit and the compensation packages offered to them would all be quite different depending upon whether your goal was the development of a company or single product.

For example, if you are trying to exploit a product idea quickly, then the use of consultants and subcontractors exclusively can give you rapid access to a large pool of talent and capabilities. However, you will not necessarily be building either an infrastructure or an intellectual property base in marketing, manufacturing, etc. that could be used for later products. Since most venture capital firms tend to invest in a combination of product, market and team, the lack of a team may limit your availability to capital.

As well, when attempting to raise funds, the potential investor is interested in how you intend to grow beyond a single product and secure a position in a market that is made safer by having multiple revenue streams and products. The investor is also interested in finding liquidity for their investment through the sale of their equity either to public investors or an acquiring company.

Now that I have shared my prior position, let me share my more current thinking:

The concept of a virtual company is moving not just to reality but to dominance. There is an emerging collection of independent specialists who, connected through the Internet and cell phones, can perform each of the independent functions of a company (e.g. prototype development, supply chain management, packaging, etc.), often better than the employees that a firm could hire (i.e. Mechanical Turk[4]). Over the next few years, we will see even greater sophistication in how one ties together independent entities to more efficiently and quickly build to success. In some ways this is a true democratization of business.

One implication of this is that royalty or equity deals may become common in these virtual structures so that members of the community share upside potential. Imagine paying for online services with cash, royalties or stock.

More entrepreneurs have found that the biggest gap in their understanding of how to start a company relates to the creation of a coherent marketing and sales plan. This is followed by a generally limited view of financing alternatives which is limited to raising venture capital.

This raises questions about the role of venture financing since no team would be built in the conventional sense. It is possible that the venture industry, which itself is not very old and dates back to the early 1980s, will phase out as these new virtual business models become more common.

2.1.2 Figuring out what business to start

Many students want to start a business but cannot figure out what business to start. They can be pictured as sitting around the kitchen table debating different product ideas in the hope of finding one that would work. Most often these business ideas tend to revolve around the Internet. They typically sound like "a website that will help a consumer do something." Most often, they are based somewhat on their own "self reference criteria[5]."

This process frequently fails because the only people around the table are typically the two or so entrepreneurs who are trying to create the business.

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[4] Amazon Mechanical Turk is a web business that allows an employer with a repetitive task requirement to hire on a "per item" basis from a pool of over one million workers who are connected over the Internet and who can use the Internet and in some cases the telephone (or Skype) to perform the task. For example, a task might be: "find me the name, address and telephone number for every plumber in the zip code of 01770" and the fee might typically be only a few cents. A large pool of tasks is then posted on Mechanical Turk (with, in this case different zip codes) and a mailing list is built at a cost which is a fraction of the cost of buying an identical list.

[5] Self Reference Criterion is the natural tendency to judge situations, beliefs and actions in different cultures according to one own cultural norms (http://www.freebase.com/view/en/self_reference_criterion)

A more effective strategy starts with the understanding that, generally, that building B2 B businesses is easier than B2C. This is principally because the value proposition(s) and decision processes are based more on logic and real financial returns than consumer preference, which can change easily. This is covered in more detail in the Value Proposition section (3.2).

Instead of sitting around that kitchen table, select a specific problem within a business. This requires engaging actual business participants who are willing to share where their frustrations and problems lie in actual conversations. Often, their unfamiliarity with current technology or their need to remain focused upon their own day to day operations prevents them from actively seeking these solutions that represent new business opportunities.

Thus, the first actionable step for finding a problem to solve is to ask all of the people closest to you, (relatives, friends, neighbors, etc.) to allow you to come in to their business and interview them in order to better understand their business model. During the interview process use the Search Selling method which keenly listens for potential opportunities by listening for pain points in their business model. This is covered in more detail in the Selling section (3.8).

Learn their business model by investigating all aspects of their business that they are willing to share. Tour their facility, ask how they acquire customers, how they build their product or deliver their service, etc. Typical problems lie in the areas of:

- Customer acquisition
- Customer service
- Efficiency of operations
  - Waste
  - Efficient use of the facility and capital
- Growth
- Cost of goods sold
- Employee recruitment or retention

This raises the general question of whether the student needs to have specific talents in an area that can lead to a solution of a problem. The answer is, unfortunately, yes and no.

Students today have far more familiarity and skill with technology than people from prior generations and are probably running the companies that you will be examining. As such, it is likely that the student will be able to envision solutions that are based upon your familiarity with technological tools observed or used for other purposes.

Alternatively, it may be necessary for the student to take observed problems to others perceived as "skilled in the art" in a field that the student suspects can help. For example, if a particular product is too expensive as it is currently being manufactured, producing it overseas might help. If the student is unfamiliar with the process of overseas manufacturing then finding an expert could find a solution to the problem.

The entrepreneur's role is to do just that: bridge together a solution and problem. The more entrepreneurs do this process, the better they become at it. Entrepreneurs tend to gather an understanding of many different business models and will often find an idea used at one which can be beneficial to another. Invention can be defined as taking a well understood concept from one field to another where it had not yet been applied. Therefore, do not limit the examination of a business because of insecurity in understanding the inner workings of that business.

The next critical step is to propose solutions in the form of a transaction to this new, potential customer. Use the "trial close" technique to determine what the true value is of your solution. This is covered in more detail in the Selling section (3.8).

The student must then confirm that other companies in the same category as the studied business have a similar pain and desire to engage in the same transaction.

As number of businesses studied increases, the likelihood that a real problem with enough pain to represent a real business opportunity will be identified also increases. The key is to understand that business opportunities start with customers who have problems and the money to pay for a solution.

The student must also determine what actual manufacturing or service costs are needed to provide the solution so that pricing can be rational with respect to the value offered. If the price of the solution is based upon an unrealistic understanding of the real cost, the value might be strong but unachievable. If the price is too high, fewer companies will become customers. If the price is too low, money is 'left on the table'. Neither of these circumstances is favorable.

Note carefully that the process did not begin by designing a website or building a prototype. Start with the selling process in order to understand the real value to the customer and whether it is rational to continue investing time and resources in the business idea.

It's quite likely to find a number of unrelated transaction "offers" to work on simultaneously. The decision on which one to focus should be based upon the relative strength of the value proposition as defined by the customer.

Keep in mind that the primary goal for businesses is simply survival. Most businesses that fail do so in the first two to five years. In the beginning, it's not a question of whether the business can grow to billions of dollars of revenue, but simply whether the business can pay its bills. Thus, the selection of industry and business is partially based upon these criteria. At any particular time, some business segments are growing, some are stable, and some are shrinking, often because of trends that are outside of their control. Actively growing markets are appealing but a new business will also actively attract competitors and often survival is made easier by remaining "under the radar" of competition, especially when large competitors can sustain loses when entering a market.

One must therefore consider, not just whether the market is growing, but also whether your initial entry will be undisturbed by competition. Starting a business in a static or shrinking market where the new business remained alone frequently has a better survival rate than starting a business in a growing market that was getting crowded. This choice requires the understanding that the business would need to segue out of this market by Year 3 after achieving cash-flow-positive results and building some mass with the organization.

For example, Leaf Systems, designed and built a portable film scanner and transmitter used by photojournalists. A vice president at Sony said that they wouldn't consider entering this market because it was too small and transient. As a result, Leaf Systems had the market to themselves and eventually grew to afford to design and build digital cameras that competed directly with Sony's.

This further demonstrates why long range business planning may be irrelevant for small startups. The key to building a new business is simply the process of starting and being in a business which will attract new opportunities over time. Getting to cash-flow-positive is the first and foremost goal.

When it is appropriate to make a "demo" of the proposed product? The key to understanding the answer is to determine what the customer believes. For example, if one can simply paint a verbal picture of the proposed solution and the customer can envision it adequately, then there is no need for a prototype when beginning the sales process. It is only when the customer cannot either understand or believe the proposal that some effort might be required to move the transaction process forward.

For example, let's assume that a company wants to make an iPhone application that was similar to an application already available on a different platform (like a PC). In this case, the customer can readily understand the product and a demo is not likely needed to determine the relative desire for the product. (This is separate from demonstrating to the customer that you are capable of building the product, which is a matter of risk and not internalization of the value system and can be dealt with in other ways.)

Alternatively, when Leaf Systems was going to introduce the world's first professional digital camera, the customer was unclear about what and how this product would work in comparison to film photography. Iit was necessary to demonstrate its operation in order for the customer to internalize the value proposition.

Strong value propositions allow entrepreneurs the opportunity to obtain the financing needed to complete the transaction more easily and at lower cost. In an ideal case, the customer is so strongly driven to the offering that they will offer financing, sometimes in the form of a deposit, in order to help you achieve the solution. Strong value propositions are the key to launching a successful business.

A strong value proposition is one where the value to the customer is found by them to be very compelling and drives them to eagerly engage in a transaction. By comparison, a weak value proposition may still be perceived by the customer as positive, but the customer is not driven immediately to action. The key to evaluating the strength of the value proposition is to measure the **customer's** reaction. Customers who are reacting to a strong value proposition will look for ways to "get the deal done" as opposed to "reasons to spend more time evaluating it."

2.1.3 Exercise – Find an Opportunity

We all have many relatives and friends that are currently working in companies with which we have no personal experience. Assemble a list of five such companies in five different businesses. When making your selection of companies to visit use the following criteria:

- Exclude companies where you have worked at any length. It is critical that you enter the interview without any preconceived notions about where there is pain and what innovations might be useful.

- Select companies that have existed for ten or more years and are currently profitable and self sustaining. Don't limit your search to large companies. Consider small professional or retail firms as well. For example, a dentist, restaurant, garage or flower shop would all be reasonable choices.
- Select a company where the management is older than fifty and is therefore less likely to be as familiar with current technology as you.
- Select a company that has a business model that is common and thus if you can find a pain point, it will be likely that there are other companies that are experiencing an identical pain.

Visit the companies using your personal relationship to get you access to the CEO or the highest level manager that you can.

Perform an in depth interview of approximately one hour each that attempts to learn their business model. It is critical that you do more listening than talking. You must not lead the conversation to a specific idea that you have, but rather you must allow the interviewee to describe their business model fully. Among others, ask each of the following questions:

- What do you sell?
- To whom?
- How do you find customers?
- How do you deliver your product/service?
- How do you build your product?
- What do you buy from other companies?
- How do you perform customer service?
- What is your most profitable product/service?
- What is your least profitable product/service?
- How do you find employees?
- Why do you lose employees?

In each case, listen carefully for "pain points." Try to identify a problem that you can potentially solve.

Observe what is referred to as the "80/20 rule." For example:

- 80% of the revenue comes from 20% of the customers. Focusing on those 20% may reveal the company's customer retention strengths.
- Often 80% of the cost of a manufactured product will be incurred by 20% of the purchased components. Focusing on the component costs of the 20% can have more rapid return.

You may observe the 80/20 rule for many aspects of a business and it will help you to simplify your model of their business and thus acquire a more rapid understanding of what is important.

Video record the interview so that you can go back later and review the search for opportunities.

Create a proposed transaction that will eliminate the pain in exchange for payment and offer this transaction to the potential customer. Record the response and attempt to modify the offer if the answer is 'no' and develop a strategy to change it to 'yes'.

For example, the garage that I use to repair my car sends me a postcard reminder when it's time to get my state required annual safety inspection. When I last was there, I asked them why they send out these cards. They replied that it was because they had only one garage bay that could be used for inspections and typically all of their customers would procrastinate and wait until the end of the month to call. The result was that their bay sat idle for most of the month and when the flood would occur at the end of the month, they would be unable to handle all of their customers and would lose business and good will. The intent of the cards (which are successful) was to get higher utilization out of the bay and increase revenue.

As a note, you will observe that I'm suggesting that you start with the development of a B2B business opportunity. In the chapter on B2B and B2C you will understand that B2B businesses are much easier to start for a variety of reasons.

2.2 The Drunkard's Walk of Entrepreneurship

The Drunkard's Walk by Leonard Mlodinow describes, in an entertaining fashion, the history of probability and statistics as a branch of mathematics that was often created by gamblers and miscreants. He also demonstrates how poor we all are at understanding and internalizing probability functions.

There are two ways in which random events influence small businesses that are critical to understand in order to find success in a small company. The first, deals with macro influences on a company's direction and the second deals with probability functions and how they apply to the marketing challenge that is unique to a small company.

At most business schools, professors teach that process is critical. The Business Plan has become the cornerstone of entrepreneurial growth. One needs to perfect an idea, perfect the plan, and go out and do it. Small business entrepreneurship is just the opposite. In the attempt to balance action and planning, current business schools teach far too much planning and far too little action. (Note that for **small companies**, the concepts of "strategic planning," "business planning," and "product planning" are all rolled into a single process aimed at making money in the short term.)

Large businesses like General Electric have hundreds of thousands of employees and millions of customers. Every day, their destiny is mostly shaped by the shear momentum of the organization. A major economic shift can influence them, but, for the most part the winds that blow have little overall influence on their day to day success.

Small companies are quite the opposite. Their comparative inertia and momentum are infinitely small. The random events that occur each day cause wild fluctuations in their performance[6]. For example, the CEO meets a business opportunity by sitting in a fortuitous seat on an airplane or a snow storm causes the entire engineering staff of one to miss the deadline for a customer or a critical trade show.

Serendipity and calamity can both have dramatically larger impact on a small company than a large company.

Small companies must approach business more like a chess player who approaches a game in progress. The player has certain skills that include how to move the pieces legally and strategic goals that might involve certain pieces or certain areas of the board as being more valuable. The player approaches strategy with a parallel set of

[6] It is interesting to note that macro events, like the 2009 recession might, have no effect or even a positive on a small company because they are so "under the radar."

alternative moves and a presumption in each case of how the opposition might respond and so on. Once a move is taken and the opposition has responded, the process needs to be reset and begun again. **Thus, the investment in planning is seen as short lived and must remain flexible.**

This is especially true in a small business where the labor and talent of the founders may be one of the only assets of the company and cannot be squandered on generating plans that are never used.

The balance between planning and action is tilted much more heavily towards action when the company starts and slowly shifts to planning as momentum increases. A small company's plan might be only as complicated as what can be described on a single sheet of paper on its first day.

A serendipitous discovery of an attractive business opportunity with an existing customer can cause a company to rapidly discard its current business model in favor of a completely new one.

The following analogy illustrates the point:

If you were dropped somewhere in the middle of the Atlantic ocean it would be pointless if you spent time trying to decide whether it is a better strategy to swim towards the US or England. You need to focus on survival and simply swim. Likewise, if a piece of flotsam was near, you wouldn't think "hmm.. that's not a very big piece of flotsam, maybe I should wait for another." You would swim to it and hold on for dear life.

Alternatively, if you were dropped at the helm of the Queen Mary in the same predicament, then thinking about how much fuel you have and which shore you can reach does make a lot of sense.

Small companies must focus on survival strategies that offer them the time to find real opportunities (pieces of flotsam that float by) and dodge crises (a shark). As they gain momentum and strength, they can cast their gaze further towards the horizon and plan with more serious intent.

2.2.1 Life, Entropy and Evolution

Angels and Demons, Good and Evil, Yin and Yang, Light and Dark, Life and Death are the contrasts that help us to understand and define the universe.

In 1863 the German physicist Rudolf Clausius, the father of modern thermodynamics, published the second law of thermodynamics and established the concept of entropy. In the second law he stated that the entropy, or the disorder, of a system will tend to increase over time. We can observe, for example, that the surface of the planet Mars has been devolving to dust over millions of years of gradual disintegration.

Just four years earlier than Clausius, Charles Darwin, the noted botanist, in his book *On the Origin of Species* described his theory of evolution. Here on earth, where life abounds, we can observe the evolution of higher and higher forms of life that increase in complexity and create order and form in their presence.

One can think of evolution as the creation of order (or structure, or information) and entropy as the destruction of order, or as opposing forces.. In his 1944 book *What is Life?* noted physicist Erwin Schrödinger (you may have heard of his cat[7]), who worked in the field of quantum mechanics, observes this relationship between life (which he refers to as "negentropy") and entropy (see figure 1):

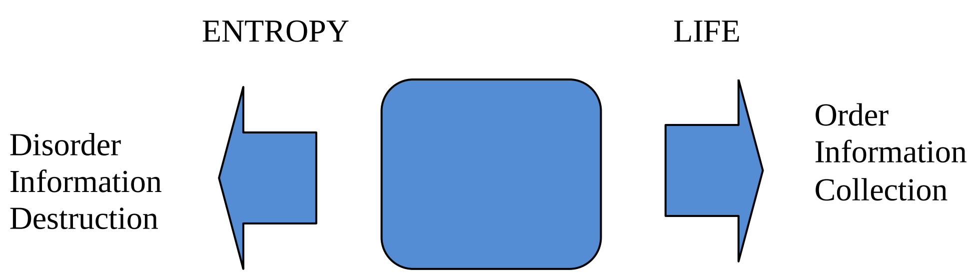


Figure 1 - Entropy versus Life

The fundamental process of life, evolution, is based upon adaptation to patterns and the creation and storage of data that embodies that adaptation. For example, plants that "learn" to turn to the sun get more energy and prosper and survive than those that do not.

These data are stored in Deoxyribonucleic acid (DNA), found in the nucleus of cells. Evolution is the process of encoding into a life form's DNA a survival strategy that is a response to a pattern of environmental risks or opportunities. It is only the repetitive nature of the pattern and billions of individual experiments that enable this type of adaptation to work. For millions of years, the only way that life

[7] Schrödinger proposed a "thought experiment" which tested certain theories of Einstein and others in the field of quantum physics. In his experiment a cat is in a box and its life is controlled by a quantum event.

could encode these patterned responses was in the genetic codes passed to offspring.

The key is that this process, evolution, is a storage of a pattern or data that is in response to an observed pattern. (Note that the term "observed" is used in a broader sense than simply as seeing.) If the sun did not rise and set in the same way, then plants would be unable to adapt to the pattern of its "anticipated" position.

Higher forms of life adapt to patterns quicker through the process of thought. The brain allows a more rapid identification of patterns and the creation of responses. Pavlovian responses[8] are examples of adaptations to patterned input.

For humans, the patterns that are observed can be recorded and passed in the form of folklore or writing so that offspring and other humans can share the adaptations. For example, hunters and gatherers observed the changing seasons and the grazing patterns of prey and increased their likelihood for survival through the process of adapting to those patterns by planting in the spring or following herd migrations.

In his famous lecture on "Life in the Universe" Stephen Hawking, a more contemporary physicist, observed that: "human evolution modifies our DNA at a rate of about one bit per year, yet by contrast there are about 50,000 new books published in the English language each year, containing on the order of a hundred billion bits of information." He observed that this "external" form of DNA and evolution is adding adaptation "millions if not billions of times" faster than the accumulation of knowledge in our molecular DNA.

2.2.2 Patterns

It's all about patterns. Patterns need to be observed (and potentially understood) in order to define behavior. People feel better when they believe that they understand the world around them and can create a plan to deal with it. People feel safer if they believe that taking their shoes off before they board an airplane will prevent the next terrorist attack because one case was observed where it might have helped. Many avid gamblers know that the house always eventually wins also believe that a certain pattern of how to pull the lever on the slot

[8] Ivan Pavlov in the 1890s observed that dogs would salivate before the introduction of food, in response to a bell. He called this "psychic secretion" later to be called "conditional reflexes."

machine will increase the likelihood of winning. They believe that they have found a pattern[9].

People don't do well with internalizing probability functions. People know that flipping a coin over a long period of time will likely result in a near equal number of heads and tails and that the next flip is independent of the prior flips and has an equal probability of being heads or tails. Yet, if a person who had just flipped ten heads in a row was asked what the next flip would produce, the tendency is to suggest that "it's time for a tail."

It is interesting to note that by law corporations are considered to be equivalent in many ways to the individual in rights and liabilities (with the exception that corporations cannot vote). Companies evolve and use the observation of patterns to establish rules of behavior that are supposed to increase their likelihood for success and survival. Business plans are essentially built upon a presumption about patterns of response to patterns of action.

Successful marketing is based upon the recognition of patterns. If, for example, women between the ages of fifteen and twenty five are more likely to buy a company's product, then more profit can be made by directing advertising to that segment and not wasting media dollars directed to segments that are less likely to buy.

But, what happens if there is no underlying mechanism that defines a pattern that can be used to guide behavior? How do humans tend to respond?

The tendency is to attempt to identify patterns even when the data are so sparse that they cannot be used to successfully predict the future. Keep in mind that the process of evolution performs billions of experiments in order to modify behavior in response to patterned input. In many cases, the observation of business success is based upon the belief that a pattern has been identified but in fact, too little experimental data have been developed to form a definitive position.

The medical industry is coming to terms with the observation that many of the predicted behaviors that were thought to "protect us" from cancer (i.e. eating well, losing weight, taking supplements) have, when statistically tested on large populations in controlled studies, shown no beneficial effect and in some cases the potential for harm[10].

[9] Some might suggest that the definition of a religion and superstition is a behavior pattern and belief pattern that is not based upon statistically significant observations. Therefore, some might consider it a good example therefore of our need to create patterns where none might actually exist.
[10] *New York Times November 13, 2009 Gina Kolata* "Drugs to Deter Some Cancers are Not Taken"

In the study of business, observations tend to be based on very small sample groups and tend to not study business failures in a way that lends credibility to developed theories. These methods would be equivalent to assembling a room full of lottery winners and then carefully interviewing each one asking how they came up with their winning numbers. The first might offer that she used the birthdates of her children, the second, used the ages of her siblings. A pattern starts to emerge; it's related to one's relatives! Had we assembled all of those who bought tickets, both winners and losers we would probably find that there was no observable pattern and the winner had been randomly selected.

Several books have been written about the tendency to see patterns where none exist. In his 2008 book, *Outliers*, Malcolm Gladwell points out how the likelihood of being a successful Canadian hockey player is influenced by one's birth month though a series of connections that are completely rational but difficult to have foreseen[11]. Improper credit is frequently given to individual with an accomplishment that was driven by external forces. Many students suggest the use of "mouth to mouth" or viral marketing as their preferred choice and show examples of successful use in the past, but importantly, can't demonstrate the critical differences between those that succeeded and those that failed.

2.2.3 Gaussian Distributions

Gambling casinos understand that normal or Gaussian distribution (see figure 2.) and probability works. They can make money, over the long term, essentially without worrying about the short term aberrations that will occur by trusting in the probabilities that they understand about the games that they offer. They also understand that they need a deep enough resource of funds to sustain the occasional good luck of a customer, but that over the long term they will win.

[11] Gladwell observes, in "Outliers" that one's month of birth (in Canada) when combined with the cutoff date for entering grade school implied that those born just after the cutoff date will be as much as one year older than those in the same grade who were born just before the cutoff date. In sports like hockey the advantage of one year of maturity at an early age is enough to result in selection and then additional investment through advanced training that tends to build a substantially higher likelihood for success.

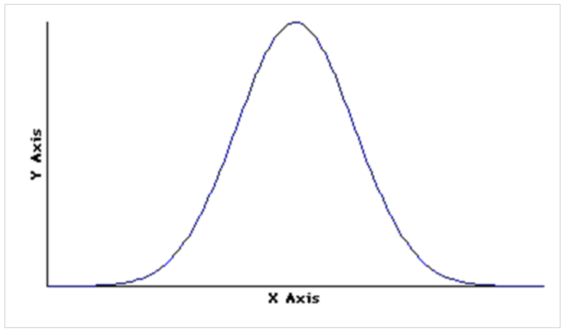


Figure 2 - Gaussian distribution

In the same way, card counters can modify the odds in their favor but they too need a deep enough pocket to be able to sustain short term losses that are part of the reality of probability driven systems.

In his 2007 book, *The Black Swan*, Nassim Nicholas Taleb casts the Gaussian curve as the villain. His theory is that it is overused and misunderstood. Taleb suggests the there are some types of events which are similar to gambling only because people "bet money" on the outcomes but which differ in an important way. They are not constrained by normal distributions and instead have "Black Swan Events[12]" that will occur for which the payoff (or risk) is incorrectly valued. He suggests that the financial industry has misunderstood and misrepresented the real risks of outlying events to customers. The latest financial collapse tends to support his theories and made his book a bestseller.

But, contrary to Taleb, one must look further into processes that are consistent with Gaussian distribution of outcomes and relate those to business and more specifically to marketing.

As stated before, humans are driven to identify patterns (even where none exist) in order to plan strategies. Most students, when defining a marketing strategy, attempt to construct a logical connection of rational thoughts that will lead a customer to accepting the transaction offered by their company. A customer's response to a marketing program will not be a linear connection of dots to an anticipated

[12] Black Swan Events' are…"First, it is an outlier, as it lies outside the realm of regular expectations, because nothing in the past can convincingly point to its possibility. Second, it carries an extreme impact. Third, in spite of its outlier status, human nature makes us concoct explanations for its occurrence after the fact, making it explainable and predictable." http://www.nytimes.com/2007/04/22/books/chapters/0422-1st-tale.html

response. Rather, customers will respond within a distribution of responses that are probabilistic and center on some average.

For large companies, this does not represent a significant problem since the market tests are big enough to adequately measure the average response. But, for small companies, where resources are limited (similar to an undercapitalized gambling casino), the response to any campaign may be so meager so as to not provide an adequate understanding of the real performance of the campaign. As well, the creation of a successful campaign depends upon constantly tuning the offer, call to action and description of the value so as to improve its performance. Each modification requires more testing.

(This is another reason why an exceptionally strong value proposition is often needed by a small company because it will narrow the width of the bell curve and reduce the number of tests necessary to get an adequate measure of the effectiveness of the campaign.)

Direct marketing on television exposes the very nature of probability functions in marketing. For example, a company might purchase a half hour slot of television on some weekday evening on some specific channel to run one of their infomercials. (This would typically be done in concert with many other slots at the same time.) Each slot would have its own telephone number and could be measured independently. The advertisement would be connected to millions of televisions but only a small number would be turned on, an even smaller number would be tuned to the proper channel, a smaller number still would be awake or paying attention, and so on.

Yet, after each run on the same channel, on the same day of the week at the same time, of the potential 33 million viewers, some random selection of ten customers would likely place a purchase order. Each and every week, ten or eleven or nine would call. Trying to postulate the process by which someone would watch the ad and call is pointless. It is more appropriate to learn to observe and trust the metrics. (My use of an average of 10 is only as an example, and the actual average would tend to vary depending upon the effectiveness of the specific campaign that is being run.)

When executing a marketing campaign, the distribution that one is interested in understanding is the acquisition cost per customer. For example, in the television direct marketing campaign discussed, the cost of customer acquisition for a single airing is the total cost of the television ad (or equivalently, the media cost) plus the cost of the telemarketing that was required to field the calls that are generated by the ad then divided by the number of closed sales achieved for that airing. Alternatively, if one was running a campaign on ad-words, the acquisition cost for a sale would be the total cost of all of the clicks paid for up to and including the one that ended in a sale. A more detailed discussion of how to calculate campaign profitability, and the cost of customer acquisition is presented in section 3.18.

The rule of thumb in television infomercial advertising is that it takes roughly 250 insertions, or around $50,000 in media cost to develop reliable statistics that will adequately test a single campaign. Most often, the results of a single $50,000 test leads to a desire to tune the campaign and run additional tests.

This can lead to a better understanding of the difference between a Gaussian distribution of results and a Black Swan Event as described by Taleb. Assume, for example, that a company has a television marketing program where they run $1,000,000 of media per year and have an average customer acquisition cost of $1, thus (omitting for now the cost of the telemarketing) the ads running over a complete year yield 1,000,000 customers. Assume that on average, each insertion costs $100 and yields 100 customers.

A bright young marketing executive suggests that it would be better if the company took the entire budget of $1,000,000 and instead bought a single Super Bowl advertisement since he has calculated that it would get reach more customers than the individual ads.

Unfortunately, a major, unanticipated news event occurs on the day of the Super Bowl and the viewing audience shrinks dramatically (the Black Swan event) and the customer acquisition cost rises to a point where the campaign is unprofitable.

2.2.4 Quantum Mechanics and Marketing

So far, the discussion of business has included genetics, DNA, and Gaussian distributions. Let's go all the way and relate small business to the field of Quantum Mechanics since several noted physicists including Schrödinger and Hawking have already been quoted. Enigmas in quantum physics can serve as good examples for how marketing must be approached.

The quintessential contradiction described by quantum theory that every physics student knows is best presented in the famous double-slit (or Young's) experiment[13]. The original experiment was based

[13] There is an abundance of information online relating to Young's 1803 experiment which has been repeated and expanded upon countless numbers of times. The fundamental contradiction that it confounds physicists serves as a good example of the difference between observing the results of a system from understanding how it works on the inside. The reader can find more information about this wonderful enigma. One particularly interesting version of this experiment can be observed at http://www.hitachi.com/rd/research/em/doubleslit.html

upon observing the behavior of light, or photons.

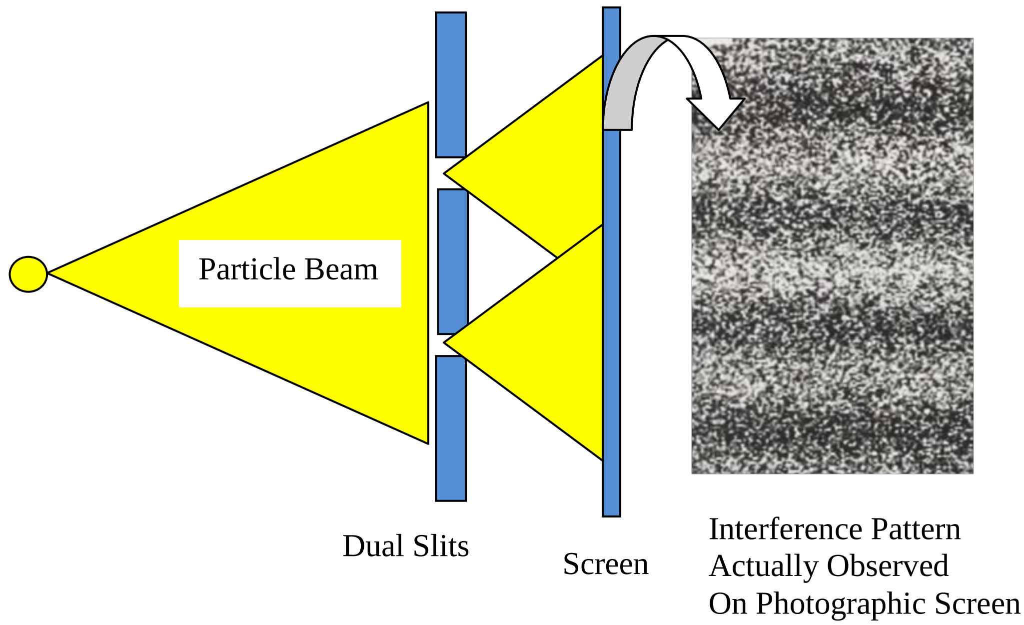


Figure 3 - Dual Slit Experiment

Basically when particles, like electrons or photons are pointed at a plate with two slits (see figure 3.) and their distribution is observed on a screen beyond the slits, one sees what is called an interference pattern, or a distribution that implies some interaction between particles that are traveling between the different slits (more landing in specific places and fewer landing in others yielding bright and dark bands).

What makes this unusual is that this interference pattern occurs even if the particles are shot one by one, slowly over time, clearly demonstrating that one particle cannot possibly be interacting with others. Physicists have for the most part, been unable to describe the mechanism by which this occurs.

Note that describing the probability function for where the electron is likely to land does not require having an understanding of the mechanism for the deflection of the electron.

Marketers are faced with the same dilemma. Often, one cannot understand the mechanism for how or why something sells, but rather one observes the metrics of a campaign and accepts them for their reality. The difficulty for a small company is to create enough data to adequately serve as a reliable predictor of the future of a campaign. Often the attempt to rationalize the behavior of the customer is pointless and is equivalent to trying to figure out why the double slit experiment works the way it does.

This becomes especially important when competing in a pre-existing category as described in the section on Categories (3.1). In these cases, one's objective is to cause a share-shift or a movement of some portion of the customers to one's product from a competitor's product.

For example, if you introduced a new razor blade with six blades, some customers will prefer to stick with their prior brand or product preference, while some will be convinced by your new innovative value to shift over to your product.

The key to understanding whether a marketing campaign is successful and yields profitable sales is to understand the probability of any single customer changing their preference. Clearly this is not literally the description of a single customer but rather a statement of the probability of customers changing, and thus, a forecast of sales given a specific population of customers.

Attempting to obtain this probability function is more practical from the collection of empirical data than through a process of analysis of human behavior. Again, the difficulty for a small company is that testing, or the accumulation of data, is an expensive process.

2.2.5 Survival

Most successful entrepreneurs (at least those with some modesty) are able to retell the apparently random sequence of events that conspired together to cause their success or those equally random events that caused their demise. They also all shared many important skills that also contributed to their success, but without exception, each also could credit "the Gods" for happenstances that were critical.

The key question is: if random occurrences have a significant influence on the likelihood to succeed in small business, is there anything that can be done about it other than to simply hope and wait for good luck?

The key answer is yes. Note the following statistical truth: If you want to live to ninety years of age, there's one thing that you can do that, from an actuarial perspective will vastly increase the odds of living that long. Live to eighty nine! Look at the actuarial tables on line. As we age, our life expectancy extends.

Thus, the critical ingredient to increasing the likelihood of finding success in small business is primarily the act of survival. If one cannot determine with any accuracy when the magic moment will occur or which events will conspire to bring success, then the only thing that one can be sure of is that if going out business before it occurs equals death.

Survival isn't simply waking up in the morning with the determination to not die. It requires a strategy that maximizes the likelihood of not being killed. In small business, survival is equivalent to having a break-even or positive cash flow which is contingent upon creating transactions that have value and closing deals with customers that yield profit.

How can one create a strategy that is based upon survival? Matthias Wagner, founder of RedShift and former CEO, is a successful entrepreneur of two former ventures. Currently, he is starting his third business. This time it is in "software as a service" and involves a software product that runs on a cell phone and PC (or MAC) and is aimed at business customers.

Wagner has studied various transaction models and decided that the best would be a fee that is based upon usage. His decision comes from a belief that his company will make more money in the long term because customers will become dependent upon his software and use it more than they might initially expect and because the selling costs will be lower if he does not require an upfront payment.

Unfortunately, his business has no capital. This type of transaction implies that he is funding the initial marketing startup costs on his own without help from his customers.

He must consider two additional factors. First, there is no reason to believe that the model used for the first transaction or first thousand transactions has any relationship to transaction models later on. He can choose to change his business model at any time in ways that suits his current needs and assets.

Second, an upfront payment of any size, from a cash flow perspective is highly attractive even if "it's a bargain" from the customer's viewpoint because Wagner's highest priority, at this point, is survival.

So Wagner is free to choose a strategy that will enhance his likelihood for survival over the short term.

Yet, even survival is not entirely enough. One must have two additional strategies: increasing perfusion and increasing credibility in order to amplify the likelihood of achieving success.

Increasing perfusion means that one is actively and constantly increasing their network of potential customers. Later on in the chapter on Selling (3.8) is a discussion of how "Search Selling" is used to uncover new opportunities.

Increasing credibility means that as one survives one must establish a reputation that attracts ever increasing deal sizes which fuel growth and stability.

For example, in a product business, one can increase perfusion and credibility by successfully engaging with a European distributor for a product that one's company currently sells only in the US. The additional business relationship with the new distributor will potentially provide additional stability, and feedback that can help modify the product and provide additional growth.

Note that it is not the demonstration of a specific minimum rate of growth year over year. Any real entrepreneur will tell you that it is a combination of the thousands of meetings with customers, vendors, peers, employees and the like that eventually leads to the eureka moments that seed business ideas with the critical sparks that lead to eventual success.

Do current methods for funding small companies lead to a higher or lower likelihood of success? In many cases venture or angel investors press a company to show year over year growth with the goal of increasing the stock price for future investors. The pressure to grow often forces the company to spend beyond its earnings and decreases its likelihood for survival.

Venture investing spurted into existence in the early 1980s. It's quite possible that their methods and concepts are not optimized for success and it is time to consider changing them. The skill and resources that investors bring to small companies is invaluable. But, as board members and advisors, the investors might be better served by changing their focus once the investment is made to achieving cash flow neutrality as quickly as possible and then to survive and evaluate new opportunities as they become apparent to the fledgling company.

Other financing options are discussed in the Financing Your Business section (2.4).

2.2.6 Lifestyle Businesses

Lifestyle businesses are often referred to in a pejorative sense, as if they are not ambitious enough. This isn't helped by our tendency to have a bit of revisionist history writing that forgets the time spent running small businesses while seeking out opportunity.

Recently a Babson student and I were discussing entrepreneurship and he remarked that "it's as if all of the success stories out of Babson are Hail Mary's." He was buying into our tendency to revise our own histories. The very concept of a Hail Mary in football is a touchdown pass that is thrown in the last minute of the game and wins through some sort of miraculous intervention (from Mary) or a turn of luck. The winning team gets 7 points in the last seconds and wins the otherwise tied game 44 to 37. But what about the other 37 points that they had earned in four tough hours of play? What about the injuries that were sustained, the effort, skill and heroism that was displayed? Had none of it happened, the score might have been 37 to 7 where the only seven points scored were from the Hail Mary! We tend not to remember the humdrum part of the game.

If you go to Wal-Mart's website and read their history it states that it all started in 1962 when "Wal-Mart begins" while in actuality, Wal-Mart can trace its roots to the 1940s when Sam Walton began his career in retailing. In 1944 for $80,000 he acquired a franchise Ben Franklin store in Newport Arkansas with sales that grew from $80,000 to $225,000 by 1948. Then in 1950, effectively unable to renegotiate his lease, he purchased a store in Bentonville (the current location of the world headquarters) and opened "Walton's 5 & 10."

I can recall many years ago that Wal-Mart's focus was on "buy America" and it only wanted to stock goods that were manufactured here in the good ol' USA. Today, Wal-Mart is the largest importer of Chinese manufactured goods in the US and can be blamed in part for driving Rubbermaid a good ol' American brand out of business[14]. Today you would probably be hard set to find an American made product in a Wal-Mart store.

The lesson is that one really doesn't know when they have started a world class company. Sam was simply trying to do business, succeed and grow. He was a creative, hard working businessman who tended to modify his business model and adapt to his customer's preferences.

The odd thing about many "lifestyle businesses," is that they actually require more initial seed capital than other business ideas. Back in 1944 eighty thousand was no small piece of change. Starting a small restaurant might require hundreds of thousands of dollars in order to pay for the initial construction costs, equipment, inventory and fund the cash flow for the first several months while waiting for your business to build to cash flow break even.

A small restaurant is unlikely to have other businesses that would be willing to "help out" by, for example, providing a large line of credit or an OEM customer. (Although it isn't a bad idea to start a restaurant by having your first customer as a corporation that lets you take over their cafeteria in an OEM deal.)

[14] Frontline Report – "Is Wal-Mart good for America"

For other types of businesses, where, for example, you invent a new product, it's more likely that you can find other OEM partners, channel partners, or vendors who will assist you by providing early funding support.

As another good example, Starbucks, with over 16,000 retail locations today, was started in 1971 by three partners, an English teacher Jerry Baldwin, a history teacher Zev Siegel and a writer Gordon Bowker who operated their first (and only) store from 1971 to 1976. That's five years running a business that sold only coffee beans and equipment until they started to figure it out and eventually, with the help from Howard Schultz who joined in 1982, after a trip to Italy where he observed the popularity of espresso bars started to modify the business model to become a coffee and espresso bar.

Today students believe that it's all about figuring out the end of the story first. They are talking about setting up their franchise before they have sold their first product.

In some cases, extraordinary amounts of capital are required as in the case of FEDEX (formerly Federal Express, formerly FDX) and it's interesting to note that they started by purchasing Caliber System Inc. in 1998. Caliber subsidiaries included RPS, a small package ground service and other similar shipping businesses that could probably be traced back to "lifestyle businesses."

There is a small piece of folklore concerning the founding of FEDEX that suggested that the initial business plan earned a failing grade (or "C") that isn't quite true. While the original innovation of hub and spoke package transportation can be traced back to a college term paper written by the founder, Fredrick Smith, while at Yale, and while, for some time he supported that "revisionist" history, in fact, he now says that he cannot recall the grade that he got and the professor is no longer with us[15].

So, in summary, there's no need to apologize for your first venture being small and there's nothing wrong with wanting a good lifestyle. Your drunkard's walk will lead you wherever it leads you.

2.2.7 The Parental Voice

In his 2008 book *Predictably Irrational*, Dan Ariely, a professor at MIT's Sloan School, describes an experiment he performed. He gave three classes three different choices regarding their required assignments for class. Each class was given three written assignments that needed to be submitted over the course of the semester.

[15] Snopes.com

The first class was given until the last day of the semester to submit all three, with the warning that leaving them all until the last minute was unwise.

The second class was given a structured schedule with a penalty of a 1% deduction for each day late. The schedule required submission of each assignment on the end of first, second and third month of the semester, respectively.

The students in the third class were given the choice of setting their own individual schedule, any three dates that they liked, so long as all there were before the end of the semester. As with the second group, late papers were penalized 1% per day. Once the dates were selected, they could not be altered. Obviously, a student could voluntarily select the last day of the semester for all three, but if a student felt that they tended to procrastinate, then they could arrange for their own deadlines and provide their own targets for performance.

Ariely found that the first class did the worst, the second the best, and the third somewhere between. His conclusion is that many of us perform better when there is structure imposed from above, which he called the “Parental Voice.”

While Dan and I both teach marketing in a business school, we differ on the lesson learned from his experiment. My students are all self selected for being entrepreneurs. They all would like to start and manage their own businesses. My experience is that part of entrepreneurship is to learn to operate and find success in an unstructured environment. There is no “Parental Voice” when you’re running your own business.

Each semester, my students are asked to grade me as their instructor and often I receive the negative feedback that they wish that I would provide more structure for them (i.e. regular assignments with clearly stated due dates).

I was just about to relent and modify my course so that much like Ariely’s, it would have three papers, with three due dates. However, with the help and guidance of some of my friends who are not teachers, but do run their own businesses, I’ve decided to “stay the course.”

Real life in the real world of entrepreneurship requires that one finds their own voice of guidance. It’s not about me playing the role of parent for my students.

The most troubling aspect of this “parental voice” is that it attempts to define the concept of success for us. We know that companies go through periods of success and periods of failure. Even the largest companies, like General Motors, have been humbled. Is it simply the amount of money that one makes that defines their value to society or their level of success?

For my class, the objective thinking that leads a student to abandon a poor business idea regardless of how much time they have put into it thus far is highly valued. A perfectly acceptable outcome at the end of a semester is to have properly discarded several bad ideas that were pursued. Alternatively, I do tell my students that "to get an automatic "A" just bring to me a purchase order (and not from a friend or relative)." Thus, while I do participate in Babson's grading process, I do leave it to my students to find their own motivation and evaluate their own sense of accomplishment and worth.

It is up to each of us to define what it is we want to achieve in life and to define therefore our own set of measurements. It's more about the trip than the destination.

Many of the professors who I work with have debated with me where business education fits on a continuum between vocational education and academic education. If, for example, one were teaching air conditioner repair, it would be relatively simple to test a student at the end of a course, present a broken air conditioner and step out of the room.

Alternatively, if one was teaching anthropology, what (or who) does one bring into the room for a test? A family from a far off land?

We all believe that there are both nuts and bolts practical skills that need to be acquired for business success and a methodology that can be used regardless of the nature of the business problem that is being confronted.

There can be some debate on each of these fronts. Regarding purely vocational skills, there is a case that can be made that none of it matters, since one can simply find someone to do it if you one doesn't understand how. The Internet and social networking are making this more readily achievable every day.

For analytic skills, the debate may center on the relevance of the particular case studies that are used. For example, starting a business in Brazil is quite different than the US because of differences in customs, regulations, and customer demographics. Studying the cases of relatively large companies does not necessarily prepare a student for the first year of an entrepreneurial venture that has no funding other than the free time of the student. The combination of the statistical bias error of only studying successes and the tendency of successful business people to recall their own history with some revisionist tendencies may contribute to lowering the value of the case studies that are currently used.

For this reason I have decided to create a new set of case studies that are based upon smaller business, cover them in real time as they are experiencing success or failure, and are selected without regard to their current level of success.

One such study is the case of Brian Hayden and Duncan Miller who started Heatspring Energy, later to be known as Heatspring Learning. In their first interview, after two and one half years of operation, we had an enlightening discussion relating to the question of "measuring success."

Both Brian and Duncan saw success initially in the form of ever increasing revenue and employee count. Unfortunately for them, their second full year of operation was influenced beyond their control by the economic. It was difficult both of them to deal with the hard realities of cutting expenses, laying off employees, and worst of all, seemingly falling back from the success that they had already obtained.

While revenues have remained flat for two years, in anticipation of growth they doubled their employee count and expense level only to find that the anticipated continued growth of revenue did not materialize.

At the time of the first interview, they shrunk the company back to its original size, two founders, and were continuing to sell courses and were, making more money personally than they had made for the past two years. It turned out that they didn't really need all of those expenses or people.

The challenge for them now was to figure out whether this "is enough" for now? Had they failed or just been affected by influences out of their control? Should they take it personally?

2.2.8 My Own Drunkard's Walk

I thought that it would be helpful if I could illustrate the random walk of a small business through my recollections of how I found financial success in my second business. These are my "raw" recollections and I am intentionally not researching the facts in order to make the story more perfect.

In this story, a colonoscopy, courage, hard work, fear, and ignorance all conspire together to lead to my company's success.

In 1987 Mario Vázquez Raña, a wealthy businessman from Mexico, who made billions in the furniture business, decided for reasons that were probably based in ego and insecurity that he would buy UPI, United Press International (UPI), the second largest wire service in the US. Wire services provide news pictures and stories to newspapers, radio, and television news programs. They offer some efficiency in that a single reporter's work can feed thousands of publications.

The 1980s were the boom times for the newspaper industry. Profits were exceptionally strong and the eventual impact of the Internet was not yet anticipated.

While having a colonoscopy at a US hospital (a preventative medical examination where a doctor inspects the inside of one's colon) Mr. Raña, who was awake for the exam, observed his colon on the video display of a computer sitting by his bed and exclaimed: "that's just what we need in the newspaper industry!" He noted the manufacturer's name and after discharge contacted the small company located in Knoxville Tennessee that made this digital imaging system for rectal examination.

With Mr. Raña's money and power and with a technical idea for digitizing images and storing them on a PC provided by the Tennessee company, the two parties approached Sony and asked them to build the third missing piece, a camera that could record images digitally, so that newspapers could give up using film.

Unfortunately, neither Mr. Raña, any of the employees of the Tennessee company, nor any of the Sony employees involved in this deal bothered to ask a newspaper what they might think.

While this was going on, my two partners and I were busy in Massachusetts making a few inconsequential products used for imaging, but not in the newspaper industry.

A friend of mine, Vladimir Nuta, who like me had experience in the medical imaging market, flew through our office one day to say hello, drink some coffee, and chat. He said, with a thick Polish accent: "Bob, I just came back from a trade show in the newspaper industry and if you could build a portable film scanner into a suitcase and scan and send pictures back to the home office, you'd have a terrific product for the newspaper and wire service industry. I've got to run. See'ya."

Well, we didn't really spend a lot of time analyzing the market. In fact we spent none. But it did seem like a fun project so we found a fourth engineer who had better optical skills than any of us, and we hired him for no salary; just a piece of the revenue if this new product was someday successful.

We all worked hard. There were long days and nights and we aimed to introduce the product at the largest trade show in the newspaper industry. Unfortunately we couldn't afford a booth. We needed to pull an all nighter' to get the unit working adequately to show it off. I left the office at six in the morning on the first day of the show, showered, met one of my partners at the airport who delivered to me the only (almost) working unit, and I was off to Chicago.

At the trade show, I read the badges of people on the floor while I carried my suitcase transmitter and if their badge implied that they were involved with photos, I asked them: "if I had a photo scanner and transmitter inside this suitcase, would you be interested in seeing it?" If the response was yes, I would actually impose myself into some other company's booth, make some room on a table, borrow some free electricity, and run a quick demo before getting asked to leave.

One such attendee was Hal Buell, the director of photos for the Associated Press (AP). Hal and I have since become good friends and his support over the years has been an important factor in my company's success. Hal loved the demo and invited me to come down to the AP corporate offices in Rockefeller Plaza, New York City to show my demo to others.

Being a native of New York, I knew that the gods were watching over me when I found an empty parking space right in front of 50 Rock. (NBC and the AP shared a building back then.)

What I discovered during that trip was that the AP had been desperately frightened by UPI's announcement of their "new digital photography system." The AP felt that it needed something "big" and "technical" of their own to announce… And, there I was, standing at the doorway with my suitcase.

Please allow me to digress for a moment. At the same time, a relatively large and well known company in the photo business, Hasselblad, had also designed a photo scanner and transmitter in a suitcase. In fact, if you placed the two products next to one another they were almost identical. Hasselblad had designed their version well before ours and had already in fact sold 40 systems to Agence France-Presse (AFP), the French wire service company that was similar in nature to the AP here in the US. Hasselblad had set the selling price at $40,000 each and had delivered 10 of the 40 and would deliver the balance in several months.

Both systems were probably within a few hundred dollars of each other in manufacturing cost which was around $2,500.

When the AP asked me what our price would be (remember that I'm ignorant of the Hasselblad product) I replied that the suggested list should be around $19,500 and that we would be willing to sell to the AP for $9,500 if they would commit to 1000 units per year and we would offer them exclusive distribution rights (an OEM deal.)

The AP had already approached Hasselblad (they did not share our ignorance) and asked them to make their best offer. The CEO of Hasselblad didn't want to lose the profit that he anticipated making from AFP on the 30 unshipped units and stuck to his price of $40,000.

Fortunately, for us and for the AP, Mr. Raña's Sony camera was just too low in resolution and quality to be acceptable to the news industry. It would take another five years for digital cameras to come far enough to be useful for newspapers.

So, we struck the deal with the AP and the $9,500,000 of revenue per year (at a remarkable profit) which helped to launch us to become even more successful.

What do you think? Was it planned?

2.2.9 Exercise – Defining and Finding Success

How do you define "being a successful Entrepreneur?" Explore not only your own feelings but how others will measure your success and how you will value that feedback in your own self evaluation. Learn about the random walk that other businesses have taken.

- How do you define success? What is it that you are looking for? What will happen to you if you achieve it?
- How will your definition of success affect how you will make decisions in your company?
- How do you define failure? What will happen to you if you fail? Can you tolerate that outcome?
- Select a successful large company and research its real beginnings. Identify whether there was an extended period of hard work and little or no growth that marked their start.
- Attempt to find the random events that drove the eventual business strategy that led to success. These may be lucky breaks or external trends that were outside the control of the company.
- Find and interview an entrepreneur and ask specifically about those odd pieces of luck that either particularly helped or hurt their company. Video record the interview.

2.3 Innovation and Technology

I am at heart, a techie, and as such I enjoy technology and science. It is as a technologist that I have come to study and understand business. Technological advancements have three ways that they impact my job:

- Many entrepreneurial opportunities come about because of technological improvements that offer differentiation in an established market.
- Technology is changing the way that new companies can be assembled and methods that they can use to reach customers.
- Technology is changing the methods that are used by teachers to reach students and convey information.

In his recent book, “The Singularity,” Ray Kurzweil, a well recognized entrepreneur and futurist, observes that the rate of technological advancements has been accelerating because technology feeds upon itself. Computers are used to design the next generation of computers and so on.

There are several issues that this raises. First, culturally we have less and less time to adapt our cultural and societal norms to changes imposed upon us by technology. After the invention of the telephone in 1876 by Bell, our grandparents had 24 years before the introduction by Marconi of the concept of wireless transmission.

Cultural concepts are often reflected in language. If my grandparents said that they just talked to someone, they would imply that they were likely to have been within a few feet of that person. For my parents, with the telephone, it might imply that they were anywhere on the planet but none-the-less heard their voice. Today, with my kids it might imply only a short text message on a cell phone.

Just a few short years ago it was considered a bit odd if you met your mate online, while today computer dating has become common. Consistent with this shortening of cultural differences, I have noticed that there is a technological gap between my undergraduate and graduate students who may only be a few years apart in age. The undergraduates are tweeting while the graduates (and the faculty) are unclear on exactly what tweeting is all about.

Generational differences that separated parents from children may soon separate siblings.

The implications are enormous as we attempt to understand the impact of technology on business. Time scales of change are shortening from years to months and soon to weeks.

I should mention that Kurzweil's concept of "the singularity" is referring to his belief that humans and machines will merge within the century thus allowing humans to achieve immortality by effectively "downloading" their software (their thoughts, personality, soul…) into a machine.

2.3.1 Technology is changing the way Business Works

I think of business as being comprised of two essential behaviors: organization and communication. Technology is radically modifying our understanding and methodology of each.

Today, for example, virtual companies are commonplace where individuals from around the world work together for brief periods of time on product or company development. For example, rentacoder.com lets a company recruit programmers from a vast international pool for a single job. Or, a logo design can shopped out to a graphic artist through 99designs.com where artists bid on design projects posted around the world.

Just as we see telecommuters who can work from their home potentially redefining the workplace, we may see the demise of the latest retail trend, the superstore, as exemplified by Wal-Mart being replaced by online distribution. As well, marketing and selling are functionally dependent upon media choices that are rooted in technological advancements.

For example, the growth of direct marketing is a direct outcome of the advancements in cable television and the Internet in providing greater selectivity in segmentation and therefore more efficient and cost effective media use. A relatively recent innovation in direct marketing can be found at spotrunner.com where they offer high quality television advertisements to small businesses that can pay a single fee of only $399 for an ad (on an non-exclusive basis) that will run in a local market. A local cable provider, that serves a small town, can sell 30 second or minute slots for as little a few dollars per insertion since the viewer population is small.

The net result is that television advertising has become available to smaller businesses. In 1995 my company spent over a half million dollars on the production of a half hour infomercial, today with technological advances, one could make the same infomercial using a desktop PC or MAC and a contemporary digital video camera at a fraction of that cost.

2.3.2 Technology is changing the Teaching Process

In my meetings with other professors, a common topic of conversation is how technology has changed the classroom. Many professors lament about the distracting nature of cell phones and laptops and wonder if we're doing our students a favor by allowing them to have access to these tools in the classroom.

Others suggest that these tools represent the reality of the current business environment and it's up to the professors to change, that we need to develop more compelling and/or interactive methods that demand more from the students in our class.

I honestly believe that I have it worse than most. For me it's not just the problem of classroom distraction but more importantly that marketing methods, the subject that I am supposed to teach, are also radically changing as a function of technology.

At this moment, for example, I and my students both wonder if and how to most effectively use social networking websites to deliver their messages in a cost effective manner. Every week I seem to learn about a new tool, the last was Amazon Mechanical Turk that was brought into my class by my students and can radically change one's approach to many aspects of business.

Much of the change that I see is what I call "the democratization of knowledge." With an iPhone in my pocket, there's very little reason for me to guess the answer to a "fact based" question. I was most recently reminded of this when my oldest daughter challenged my ignorance on the subject of "how old trees are?" (I never thought that they were as old as they are, literally thousands of years in some cases.) It's not my ignorance that is so surprising, but rather the ease with which she could find the right answer online.

Michael Mozill, one of my fellow teachers here at Babson, instructed his undergraduate students to read a particular case study. After the reading, he asked "how many knew what ebidta was?" None raised their hands. He then told them that they had fifteen seconds to figure it out. The iPhones, laptops, blackberries all clicked and before the deadline all had the Wiki definition. Michael's point was that there is "no longer any reason to attempt to understand a case study while not knowing a critical fact." He went on.."that when I was a kid your age, getting a definition meant: putting on your coat, walking to the library, looking it up…" You get the point.

This raises two interesting questions:

1. If information is free and available to everyone, then what will the next most important attributes to achieve success in our

society? Fact collection might simply not matter. Are we teaching that "next essential skill?" I suspect not. I believe that it will center on creativity and non-compliance.

2. Can we encourage the growth of entrepreneurial behavior at the bottom of the economic ladder by providing access to knowledge to people that are not yet on the Internet? For example, can the distribution of fundamental information about incorporating, sourcing materials, selling, farming, cooking, etc. to the poorest in our society empower them to find inclusion in our system? I suspect that we can, and that a combination of the following would contribute to building entrepreneurship at the lowest levels of society:
    a. The ubiquitous nature of the cell phone – currently there are over three billion cell phones used throughout the world, expected to grow to five billion by 2015.
    b. Inexpensive call centers – that receive questions from local entrepreneurs in local languages.
    c. Knowledge based database systems located at the call centers so that questions, once answered, need not be researched again.
    d. Involvement of local students who can research the answers to business and technical questions that are raised and enter those answers into the call center database systems.

I have, however, a more troubling question concerning business education. In my second business, I hired a vice president of manufacturing who was a few years older than me. When we sold our business he was able to retire and he felt like writing a book in order to share what he believed he had learned about finding success in large companies.

When I read his book it was apparent to me that many of his concepts were rooted in corporate structures that had become obsolete.

If technological changes are changing business models, then how relevant are the business models that we teach which are based upon case studies written years ago? How relevant are many of the business practices and methods?

On one level we believe as educators that we are teaching methods of rationality and analysis that can serve in any business model, but as well, business education is also in part vocational in that it teaches basic tools and methods that we believe simply work. These are the most likely to become obsolete.

This does imply that the greatest value that we can offer is to provide students with a rational framework from which new entrepreneurs can adapt to new business models as they develop. But, I observe that students want just the opposite. They want to hear simple formulae and directions for starting their business. And, while teachers like myself for whom understanding of business is rooted in experience as opposed to academic study can offer such “tips and techniques” it is also true that in a dynamically changing environment it is we who will become obsolete more quickly because the business models that we understand will disappear even more quickly than before.

2.3.3 Technology Offers New Business Opportunities

As well, many, if not most, business opportunities are driven by advancements in technology. In Robin Waterfield’s book “Why Socrates Died” he builds a wonderfully interesting view of life in Athens in the period of Socrates’ life around 420BC. It was interesting to note that most Athenian citizens didn’t really need to work since their basic needs were met by the spoils of wars and conquests of others.

(It’s also interesting to note that the adults of the time considered their children’s hair to be too long and their music to be too provocative. We haven’t really come that far in the last 2500 years.)

In the USA we really don’t have a very different life from that of the Athenians (at least while they were still winning the Peloponnesian Wars). In fact, seventy percent of our GDP, is based upon personal consumption[16]. Food, housing and apparel accounting for almost 50 percent with apparel growing the fastest (11%) between 2003 and 2004. It is remarkable to understand that our contemporary western societies are so productive that they can put so much effort and resources into the creation of comfort and entertainment as opposed to survival. In the US less than 1 percent of the population is engaged in farming[17]. Humans are unique (to a great extent) in our ability to have created so much leisure time. If you observe most animals they expend every waking hour busy with the task of mating, eating (or finding food) or raising offspring. Human language and thought has allowed us to create tools and methods that afford us enormous productivity in comparison to our survival needs.

[16] Hoover Institution Stanford University
[17] USDA 2008 farm census

Innovation and technology is responsible for much of that. We no longer need to live on the spoils stolen from others, as the Athenians did, but have innovated our own society into the ability, for example to feed ourselves with only a small percentage of us working on growing food.

And yet, technology continues to drive us to raise productivity levels and improve the quality of entertainment and comfort that is available.

In many cases, technology digs us into a hole and then builds us a ladder to get out. Today some of the problems that plague us, pollution, global warming (if you agree that it is manmade) and untenable inequalities in wealth will most likely be addressed by the introduction of new technological solutions. For example, it was recently stated by Esko Aho, former Prime Minister of Finland and currently Executive Vice president at Nokia, at the 2009 MIT Legatum forum: “the ubiquitous nature of cell phones (over 3 billion currently in use, estimated to grow to 5 billion by 2015) has stimulated more economic development than all of the charitable giving thus far.” (Maybe he’s a bit biased?)

The conclusion is simply that one must embrace and study changes in technology in order to easily identify emerging business opportunities and that the faster technology changes, the more opportunities arise.

2.3.4 Innovation

I have a friend, Dr. Jay Stein, one of the founders of Hologic and a physicist by training, who said: “the first day of a product’s conception is its best and it’s downhill from there.” He correctly recognized that the technical difficulties of implementation, the real limitations in achieved performance, the distribution challenges and the support issues would all come to light later, but now, on its first day, this newborn was beautiful.

I tend to think of conceived innovations as being of one of three types: Product Centric, Customer Centric or Distribution Centric.

One often hears about a “product looking for a problem.” All too frequently I have witnessed the invention of new products where the prototype already existed but the need was not first established and the inventors then went about trying to identify a customer with money who might want to buy the product. I frankly see only one problem with this approach. Frequently, the inventor falls so deeply in love with the invention that he is unwilling to face the reality when there is not a compelling value proposition or a customer base large enough to make it a worthwhile enterprise. And, their love and devotion keep them attached too long to a bad idea.

One of the most dramatic examples of this that I came across as part of my consulting business was "the pizza man." Puzant Khatchadourian is a charming Armenian New Yorker who is a marvelous mechanical engineer and inventor. He had made a fair amount of money in the jewelry business by building machines that could create intricate jewelry items that would otherwise have been virtually impossible to manufacture. Back in 1992 he had an idea that the world needed a "totally robotic pizza vending machine." His concept was that he could build a vending machine that could prepare and cook a delicious fresh pizza in just a few minutes from raw materials stored refrigerated within the machine.

When I first visited Puzant in 2009 in his New York office and manufacturing space I saw four such vending machines lined up against the wall ranging from serial number one to four, demonstrating the evolution of the idea over seventeen years of development!

Puzant had been working on his invention for that long. He had evolved his machine through several radical variations and spent over seven million dollars in doing so. He had burned through not only his own life savings but millions from friends and family investors who love him, his enthusiasm, commitment, talent and I should add, heritage. His investment community was comprised mostly other Armenians who wanted to both make some money and support a fellow Armenian.

I watched with complete fascination as the current version prepared a perfectly round pizza from a cartridge of dough, added cheese and sauce, sliced and added some pepperoni and then baked it to perfection.

As if that was not enough, the machine then folded a box and spun a custom designed and tooled pizza slicer (with a compartment for hot pepper flakes) into a napkin along with a fork and dispensed the boxed pizza and the cutlery to my fingertips.

Lest I forget, Puzant had also placed a large screen HD color TV into the front of the vending machine so that he could sell advertising videos as part of his plan.

As we spent a bit more time understanding his business strategy, I learned that he also wanted to sell the preformed dough; pre packaged sauce and cheese, and establish a set of trucks that would distribute the "razor blades" and manage the network of vending machines.

The only problem was that he was out of money. His current burn rate was around $150,000 per month and he had less than one month's cash left in his bank account.

As I interviewed Puzant, the most remarkable part of his story was the number of times that he was approached by large companies that were interested in doing business with him. Each prospective customer had their own vision of how to use his technology. Some were only interested in the core of the machine that made pizza and saw it more as a piece of kitchen automation equipment. But, Puzant was stubborn about his vision and was unwilling to be dissuaded from his mission to launch a fully self contained vending machine along with an entire empire behind it.

Finding the balance between focus, determination, and opportunism is a difficult challenge for every entrepreneur.

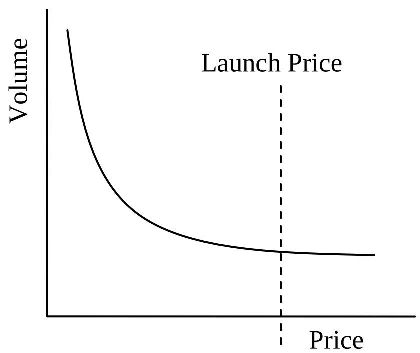


Figure 4 - example of simple inverse relationship between price and volume and selection of a higher price as a starting point for small company

There is a simple test that I have often applied to new product ideas to help gain an understanding of their true commercial value. The test rests upon two general principles. First, for most markets, volume will vary with respect convenience and inversely with respect to price. What is important to notice about this inverse relationship is that even cumbersome and expensive solutions will find some customers in real markets. Then, as the solution gets better, and cheaper, the market broadens. One must be especially critical when defining the "better" nature of the solution. For example, the early Apple Newton (Apple's first PDA) was somewhat cumbersome and expensive but still validated the PDA market through limited sales to early adopters. Thus, one should be able to test the validity of a market even with a product that is not perfect and is too expensive to achieve maximum return. If a few customers can be satisfied with an imperfect product then as the product matures and the price comes down, greater economic success can be realized. Just think about Windows 3.1. I prefer not.

Second, it is helpful to separate out different aspects of the innovation and test them independently with other pre-existing products or customer assumptions. Let me give two examples.

I was approached by the developer of a new electronic pen device which would digitize handwriting input. This particular innovation was both a new method of accomplishing this feat along with being small in size and thus having more portability in comparison to pre-existing methods, i.e. a digitizing pen as opposed to a data tablet. The inventor told me that he had been approached by an Asian employee of Intel who told him that this would revolutionize computer usage in Asia since keyboards were not a good fit for entering the pictograms usually used in Asian languages. My client felt that he stood to make millions.

I suggested that he approach the question in the following manner: Was it true today that data tablets had replaced keyboards for data entry in Asia? Would the specific difference between your innovation and pre-existing data tablets cause explosive growth in the market? The answer to both questions was essentially “no.”

As a second example, I am currently helping a company that has built a non-invasive medical system for fat reduction in the legs and thighs of the customer. The machine must be bought and used by a technician in an environment similar to a spa or cosmetic surgery office. The board of directors was wondering if the market potential extended to hair and nail salons. I suggested that as a solution we consider that there were similar types of systems today for the reduction of cellulite at similar price points and while these systems were successfully found at the offices of plastic surgeons, cosmetic surgeons, spas, etc. they had not found their way in to hair and nail businesses yet. Thus, the barriers to entry to nail and hair salons was needed to be understood and possibly this innovation was not the difference that was required to overcome that barrier. Note as well, that even the largest and most successful hair and nail businesses had not broadened their businesses to include cellulite reduction through the purchase of these machines thus implying that it might not simply be a matter of financial strength.

I should also note that sometimes things appear to not be true simply because they have not been tried yet. While these thought experiments (known as Gedanken Experiments) are useful in creating a strategy, sometimes it is worthwhile to simply go out and try something in order to clearly understand why it hasn’t yet worked. You may discover it’s as simple as that it has never been tried before.

2.3.4.1 Product Centric

Most innovations by entrepreneurs that I meet are of the prototypical form where an inventor creates a product (or product concept) born out of his/her own observed set of needs combined with a spark of creativity. Many refer to this somewhat cynically as meeting only a "self reference criteria." While it's comforting to know at least one person would buy this product, you, often the real problem with this approach is that it can lead to products for which there are only limited market needs or weak value propositions, or worse, the requirement for extraordinarily expensive distribution strategies.

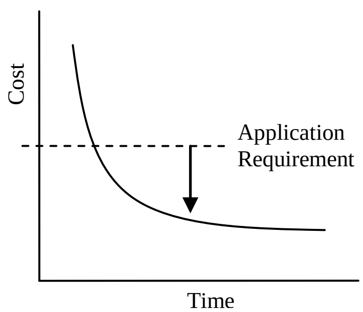


Figure 5 - Moore's Law - 2X every 18 Months

In high tech, my own field, innovation is most often the modification of cost-performance which allows new market usage and growth for a previously established idea, albeit at a lower cost. For example, digital cameras were used back in the 1970s for astronomy, in the 1980s for machine inspection systems and eventually found their way to cell phone cameras and pocket digital cameras which today sell for less than tens of dollars.

Sometimes, the relentless reduction in the cost of high technology solutions that results from Moore's law[18] silently passes by the threshold for use by a particular application. In cases like this, pressure can build for the adoption of the technology in the new application until it is finally discovered. For example, in my second company, Leaf Systems, we introduced a product that modernized the transmission of newspaper images from a field photographer to the home office. This application had not seen a technological improvement since the 1940s. As such, when our product, the Leafax-35, was introduced, there was rapid adoption by the industry.

Later on I will describe the important distinction between innovation within an established category versus innovation that develops a new category. Most innovation in products is of the former form and is

[18] **Moore's law** is about the empirical observation, that at our rate of technological development, the complexity of an integrated circuit, with respect to minimum component cost, will double in about 18 months. (source – Wikipedia)

simply pushing an established category slightly forward with a marginally new improvement, building upon prior innovations.

2.3.4.2 Product Development

I have frequently witnessed the tendency of developers to never be quite done with a product. There is always an improvement that can be made. It is the responsibility of the CEO and/or marketing group to know when it is time to give birth. **That time can be recognized as when the value proposition for the current feature set is adequate to close sales as proven by empirical data.** Additional innovation and enhancement is better left for a future version and the opportunity to either sell an upgrade, obsolete your own product, or respond to competitive reactions to your launch.

Every time you make, even what might seem to be the most insignificant change, to a product, you reintroduce the need to do what is called regression testing – or retesting all of the functionality even if it has been tested before. The more complicated a product is, the more likely that any change will have unintended consequences. Testing is time consuming and expensive.

Therefore, every time you change a product, if you do not test adequately, you will introduce the risk that the product will fail in the field and you will need to either take it back, repair it or again modify it, none being a very attractive alternative. It is essential that someone other than the developer apply pressure on the organization to stop the development process for a deliverable version of the product and launch the product while continuing development for future versions.

I cannot emphasize strongly enough the value of testing your product before you begin to build any large number. The cost of dealing with a problem in the field is significantly larger than dealing with the same problem before launch. Once you have tested, you must restrain yourself from making changes or "improvements" unless you are willing to retest before launch.

Often, entrepreneurs are reluctant to lose market opportunity and therefore tend to skimp on testing and rush products and manufacturing into a market prematurely. In general, I have not found this to be a good idea. Patience is a virtue in product development.

2.3.4.3 Customer Centric

Alternatively, one can begin with a customer that has both a problem that you can solve and the money to pay you for the solution. In reality, this is only different from the Product Centric approach in that you have doubled the number of people involved, namely: you and your customer and thereby have reduced the chance that you are deluding yourself. Obviously, the success of the innovation still rests on being able to find similar customers out there. *Of course, there's an exception to every rule and one big solution sold for a lot of money to one big customer is probably just as good as finding multiple customers; the best example being the US Government*.

An important difference with the Customer Centric approach to product development is that you can intentionally bias your search for an innovative solution towards customers that have the attribute of being in large and growing industries, thereby increasing the likelihood that you are able to create a rational marketing strategy later on. For example, in my second company, Leaf Systems, we aimed at the newspaper industry during the 1980s when they were making lots of profit and there was lots of competition between alternative wire services and newspaper chains. Our innovation gave an edge to one wire service, the Associated Press, and therefore the value to our customer was amplified by the impact that it had on their overall business. I discuss this example later on in the OEM section.

In many cases, innovation is born through bringing new people with skills in new disciplines into an old industry. For example, a computer whiz kid, the son or daughter of the owner of a business might create an innovative solution for their parent's business. The better you understand the real workflow in the industry that you're trying to help, the easier and better your efforts will be to provide an innovative and financially viable solution.

As suggested elsewhere in this book, business opportunities can be discovered through the investigation of existing businesses, the identification of problems and the use of technology to offer innovative solutions. At times, it is consistent with this concept to consider a career move where you identify older industries with lots of money, and growth, and take a job with the intent of learning the industry, and then applying your skills and understanding of technology or marketing to those older companies. Liberty medical (Polymedica) is an interesting case in point and is covered below.

2.3.4.4 Distribution Centric

Some new endeavors have no real product innovation but instead are creative methods for distribution and marketing.

Innovation in the delivery method for an established product can also offer tremendous opportunity. For example, Polymedica under the

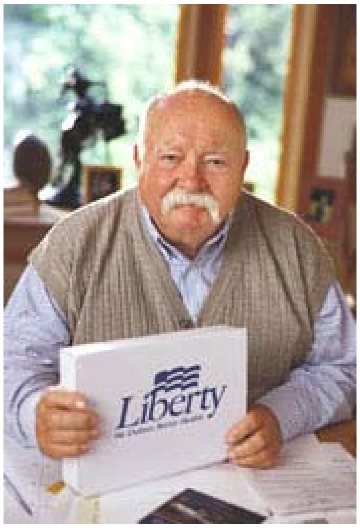


Figure 6 - Wilfred Brimley selling Liberty Medical Products on TV

brand Liberty Medical Supply, created the concept that relied upon an understanding that older Americans on Medicaid often had diabetes and required insulin and testing kits. As well, this population was not particularly well equipped to deal with the healthcare industry, and finally, almost by coincidence, they were, as a group, more than likely to be watching a new and innovative form of marketing, television infomercial advertising. Putting all of this together, Polymedica created an infomercial campaign with the actor Wilfred Brimley (shown in the photo), which proposed "taking the hard work out of getting your diabetes supplies if you were on Medicaid. Simply call us, we'll do the rest and you will get your supplies through the mail." A $450M business was built virtually overnight. More detail about Liberty Medical Supply is available in an Attachment.

2.3.4.5 What they all have in Common

In each of these three cases, they all share important attributes: The customer was experiencing pain, the customer had money and the vendor eliminated the pain and took some of the money in return.

It is also interesting to note how many businesses are built on the simple value of increasing "convenience." This tends to increase productivity and leisure time, thus increasing the demand for more toys.

2.3.4.6 Market Research

Many students use surveys to obtain customer preferences, however, survey data can easily lead you in wrong direction if you are not careful. Two common problems that I have observed are caused by using averages incorrectly and by biased testing.

For example, imagine a survey whose purpose is to help design a rake. Half of the respondents ask for a one-foot, short handled, rake ideal for cleaning around flowers while the other half asks for a three-foot, long handled, rake, for cleaning the lawn. One can take the survey data to imply that one should build an average two-foot rake, which unfortunately nobody wants.

When competing in a category, the goal is to share shift some customers away from other products by meeting their needs and offering one (or more) additional values that entice them away from the competition. Therefore, for the above example, it's essential that you first decide whether you want to compete in the short or long handled rake sub-category, and then add your differentiating value to that.

Biased survey results can occur from either sampling a pool of potential customers that are not representative of your real market, or by asking questions in such a way that it leads to an answer that may not really represent the customer's actual desires.

Students often survey other students because they are easy to reach. But often, those students do not represent the demographic that they are seeking.

Focus group testing can also be distorted by the bias of the moderator or by group interactions that are based upon the personality of one or several group members.

Focus group studies can be purchased from marketing firms that have experience in performing the process. But unfortunately, I have seen focus group analysis fail more frequently than it succeed and I suspect that much like survey data it is was the bias of the moderator, the phrasing of the questions and the subsequent interpretation that led to the failure.

For example, I watched a focus group that was run by Polaroid when they were investigating the digital camera and digital printing space. The moderator asked the question: "what makes a good photo?" expecting a conversation about color quality or resolution and the members of the group answered: "you know… like when the eyes are open."

To me, a more valid method of research, and the one that I suggest students use, involves the "trial close" where you actually try to sell the product, even if it doesn't yet exist. This is especially useful in business to business opportunities. Achieving a real sale where the customer has reached the point of financial commitment is far more informative than an opinion. When performing a trial close, you are proposing to a potential customer that you are willing to make certain modifications, or to complete the proposed product, but only conditional upon their willingness to issue a purchase order which is itself, conditional upon your successful implementation of the modifications or completion. For example: "So, Mr. Smith, you're telling me that if I could make my widget half the size that you would buy it. Would you be willing to give me a conditional purchase order for 10,000 units with no obligation to you if I fail to get the size down to your requirements?"

Some companies will run limited advertising for products that do not yet exist to simply see what the level of interest might be and at what price level. In most cases, the development of real marketing data before product development is started can save the company time and money. In the direct marketing field this is referred to as a "dry run."

I don't believe that it is ever too early to talk to real potential customers and to attempt to extract real commitments to buy based upon your meeting a set of mutually agreed to objectives. As I described earlier, building a new company is like putting on a show and I have found that most people want to participate in the process, even your potential customers. Engaging them with your enthusiasm and spirit of determination can result in convincing even a large company to take a risk on a new endeavor for the benefit of the innovation that you are offering.

If I return to my garage example, let us assume that you interviewed a garage owner and discovered a problem that their state inspection bay was only being used at the end of the month. The owner saw it as a wasted asset and wanted a solution. You could approach a trial sale with a statement like: "I believe that I can fill your inspection bay much more efficiently by using a direct email marketing plan that reminds the customers to inspect their vehicles earlier in the month along with a web based schedule tool that lets them make their own appointments instantly, online. I can provide this service to you at a cost of $500 per month and I believe that it will increase the utilization of your inspection bay by a factor of two for the first two weeks of the month. Are you willing to give me a purchase order for the first month and see how it works out?"

At this point, the garage owner is forced to consider whether this problem is really that important to him and whether $500 is worth the solution. Obviously, there's an opportunity to both negotiate the value and develop real evidence of the financial value to the customer in real revenue terms. As a side comment, it's often more important to close the first deal than to get the price right. The first customer can help you to establish what the real value is after installation (and hopefully success) and that data can help you to rationally price the product for future customers. It's much more important to simply get going than to get a few more dollars for the first engagement.

2.3.4.7 Is Innovation Required?

Innovation is not required to start a successful business. Most businesses that surround us are not particularly innovative. Most offer goods or services that are pretty much equivalent to those offered by their competition. Most, therefore, engage in the attempt to share-shift between their business and others within their category without much careful analysis or action.

For most businesses, advertising is limited to the Yellow Pages, the sign on the store and possibly a few inserts in town mailings. As well, share-shifting is, for the most part, modulated by price shifts, and most of those are motivated either by seasonal events or inventory problems.

Ask yourself why you choose to eat at a particular restaurant, or use a particular gas station, or shop at a particular grocery store. Often, the differentiator is simply the location of the business and the convenience to the shopper at some moment in time.

It is possible for you, as a student of business, to simply open or buy a conventional business and then attempt to apply the skills that you learned here to successfully shift customers to your business and away from others. One would think that you should have an unfair advantage. Let me know how it works out.

It is also true that the advent of the Internet, EBay, digital cameras and sophisticated publishing tools have enabled small businesses as never before to create and execute marketing programs. My favorite example is the wife of a friend of mine, Susan Wrisley. She's an artist who makes craft items that are fairly inexpensive.

Susan exclusively sells her creations through EBay [artsandcats]. Fortunately for her, she is a cat lover and all of her creations are cat oriented. The interesting observation on EBay is how many cat related items are sold each day. I had a friend, Mike Cronin, the former VP of Marketing for "Computer Vision" during their growth years who advised me: "If you want to catch a lot of fish make sure that you're fishing in a stream with a lot of fish." There is an enormous population of cat lovers and collectors and many of them buy their "stuff" on EBay. As such, Susan has an enormously profitable business. She's quit her day job in high tech and now focuses on making cat stuff.

EBay offers you an interesting peek into consumer activity and preferences. By typing in a word, or category, it's possible to see numerically, the offering activity within that category. For example, today there are more dog lovers (94,791) than cat lovers (71,640). You can use this information to help you pick a category for a conventional business. For example, if you were to open an art pottery business, it's more likely that cat and dog items would sell than, for example frog items (only 15,750 today.)

In my own career, two of my three companies were started as consulting entities that subsequently discovered product opportunities through the customer interactions established through the consulting business.

So, in summary, the best advice is simply "just do it." Starting is key.

2.3.5 Learning to Start Small

Often, I find that students are paralyzed when attempting to start their business. This often occurs as a result of a process by which they begin analyzing their opportunity and with each successive round of analysis they uncover additional considerations and the barrier to starting appears grows even taller. In the industry it's referred to as: "Analysis Paralysis."

Generally, most students start with a fairly simple concept, but then they are encouraged to think about how big these businesses can grow and in the process they lose sight of the simple beginnings of the idea. Let us consider, for example approaching the music business with the following idea. I'd like to create a website that serves as a marketplace for musicians and music lovers. The musicians upload their music, the music lovers, or customers, listen and pay. It's a fairly simple idea and can be pictured as follows:

Figure 7 - Web example of market segmentation

Likewise, we can consider the music industry to consist of many dimensions from which we can approach it. These dimensions might be, for example, the geographic region like "New York," or the genre like "Country Western." Often the number of dimensions that describe our market can be many more than two. Identifying these dimensions is what offers us the belief that the market potential is vast and therefore the business opportunity is worthwhile.

When attempting to start, our greatest problem is likely to be creating a transaction with a qualified customer. In our example, that might mean finding a Listener and Musician who were successfully connected on our website. Unfortunately, if we dilute our marketing investment when attracting musicians and listeners (customers) we reduce the likelihood that a particular listener will find something that they like. For example, we find a listener who is looking for "Country Western" but the first 100 Musicians that we successfully attracted only included 3 Country Western artists, and none appealed to our customer.

Thus, the key to starting this business is to "start small." Namely, in this case to select a single dimension or set of dimensions that increase the likelihood that our limited investment in finding musicians and listeners creates matches. In more specific terms, narrowing our media campaigns to collect "Country Western Musicians in Dallas" and "Country Western Enthusiast Listeners in Dallas" might yield more efficient use of our marketing dollars and a shorter path to cash flow positive.

Eventually, if our initial campaign is successful, then we can add a second dimension, for example, a second genre or a second city, slowly expanding our business.

2.3.6 Web Businesses

I have observed a number of student teams which are attempting to start web based businesses. For the sake of analysis, allow me to break them down into the following classifications:

- Service business that facilitates transactions between individuals with a fee based upon the successful transaction
- Web publisher with a revenue stream based upon a combination of subscription fees and/or advertising
- Web expansions to a current business model

For expansion of one's current business onto the web, the infrastructure of your current business including inventory, purchasing, shipping, receiving, billing, etc. are all typically in place and the web offers an additional use for this pre-existing infrastructure. As well, there are methods, like Google ad-words that can be easily used to bring new potential customers to your new website. Therefore, this type of web model is relatively simple to get started. The principal problem may be an inability to get it to grow beyond a limited value.

Alternatively, for both the service business and the editorial web publisher there is a substantial problem relating to the difficulty or expense of getting some initial momentum adequate to create revenue. For example, without the subscribers, advertisers see no value in advertising on your website. Similarly, for service websites, buyers are interested only if there are active seller markets (and vice versa).

For these two web business types, there are three different ways that one can potentially start their businesses.

First, these websites can use a massive advertising campaign that covers both conventional media as well as the web with the goal of bringing users (readers) to the site. Two such examples are Vehix.com and Monstor.com who run active television ad campaigns for this purpose. Unfortunately, this requires a substantial amount of seed capital.

Second, and less expensively, it may be possible to select a narrow vertical market where it is possible to broadcast the advertising message with significantly higher media efficiency and therefore less cost. The vertical niche could be based upon geography or any other classification. For example, if one had a web business with national potential, one could still choose to start by targeting only residents of Wellesley. For this first campaign there would be a corresponding limitation of selling to advertisers who are interested in reaching only Wellesley residents. As such, both the advertising cost per lead as well as the cost of the total campaign necessary to reach all of the residents of Wellesley and all of the potential advertisers interested in Wellesley would be quite limited and within the reach of a startup. As revenues build, new geographies are added.

A third alternative is based upon the OEM business model. It may be possible to identify current websites who serve the user base that you are targeting and you may be able to offer them the ability to use your IP as part of their website to increase their revenue and functionality. In some cases, the further they are from your business, the likelier that your IP will remain protected. Of course, the principal advantage to this approach is that you get to leverage your OEM's pre-existing customer base, advertising structure and infrastructure. The disadvantage is that if your IP is not strong, then you run the risk that your OEM partner will seek to simply "do it themselves" without your help.

I am a strong advocate for using the OEM model whenever possible as a way for small startups to grow without the need to bring in equity capital along with the partners that invest it. There are several reasons for my bias. First, it allows the startup to use all of its profits for the improvement of its IP and thus the continuation of the likelihood that their business will survive. This level of focus on a single problem is essential for small businesses.

Second, it minimizes the time necessary to launch the business and since all inventions get old quickly it therefore maximizes the likelihood for your being able to build your business in a competitive environment.

This semester we have several web based business ideas. In each case, I tend to find a combination of an IP position that seems viable with the difficulty and improbability of being able to overcome the startup problems associated with building the initial inertia necessary to succeed. Not long ago, it might have been possible to raise capital for this purpose, however, this has become, of late more difficult. As well, I need not remind you that the dot-com bust was possibly due to there being too much capital available too easily to these types of companies.

I urge each of the web based business teams to take some time to consider the potential of an OEM strategy, even if it leads eventually to a resulting business that intends to break ties with the OEM partner and go it alone after achieving some revenue.

2.4 Financing Your Business

When financing your business, there are two essential questions: first, how much will you need and second, where will you get it. There are many sources of capital, some of which are listed below in the order of preference from my perspective.

Source	Issue
Customers	Your customer has a vested interest in your success and the success of your product. This leverage helps get attractive terms, in some cases as good as a simple deposit on an order that can be used to finance the development.
Channel Partners	Like customers, your channel partners have motives related to the success of your product that can make the terms of obtaining cash more attractive to you.
Vendors	Your vendors may be looking to expand their reach or volume and may see your innovation as one that can help them. Thus, their interest in the success of your product can make them more flexible on payment terms.
Employees	Sometimes giving stock to your employees in lieu of salary (or part of salary) can create further motivation along while continuing to keep the control of the company in the employee's hands.
Angels	Individual angel investors who are from your industry may be more interested in assisting a new entrepreneur and as such may be more generous with negotiated terms.
Friends & Family	While it isn't fun to be harassed by your uncle to see how his investment is going, and you also risk the potential of damaging family relationships, the terms of a loan or investment can be more attractive to the entrepreneur.
Venture or Angel Groups	These groups offer lots of cash, but have rigid terms and conditions that force the success of your company to be high if you are going to share financially in that success.
Mortgaging your own assets	This is the avenue of last resort and puts you and your family potentially at risk. I therefore strongly recommend against it.

Regardless of how you choose to raise needed capital, the key to your success is to get to a positive cash flow as quickly as possible. Only then, are you truly running a business and not a charity. At that point, you will have the necessary leverage to raise additional capital only when the terms are acceptable to you.

I am constantly amazed at how easy it is to spend other people's money. The closest thing that I can find to it is drug addiction. And, I am formerly an addict (addicted to spending venture funds).

As a result, like most reformed addicts, I cannot stand the concept of borrowing money or selling stock to investors as a way to grow a small company.

I am constantly reminded how easy it is to become addicted.

One of the small companies that I help was founded by a college dropout, Eric Andersen. The company is called MySeniorCenter.com. Recently, Eric came to me with a desire to borrow $75,000 so that he could meet cash flow obligations through the end of the year, about three months away, when he expected his market to turn around.

As in the case of Heatspring which I discussed earlier, Eric was attempting to rationalize why his business had become difficult during the worst economic downturn since the great depression. He felt that somehow, the optimism of his customers who hoped for better funding "next year" and who really wanted to buy his product would reflect in an uptick of sales for him. He took personally the current dilemma that he found himself in, namely being out of cash and unable to afford the expenses that he had taken on.

Together, in October, we went over his cash flow projections and his balance sheet. I was troubled to find that he had bank debt in excess of $225,000 that had accumulated over the course of the last year of operation. His assets and remaining liabilities implied that he had enough cash for one or two months of operations without any new business. And, while is sales group was still optimistic, they did feel that most new orders were going to be pushed forward into next year.

To be fair, $175,000 was a buyout of a former partner that was financed by the bank and was paid back at a rate of around $12,000 per month; not terribly more than his former partner's salary. But, $50,000 was represented by a revolving line that had been completely exhausted.

Eric had difficulty understanding that technically, his company was insolvent. It had no value. He took this statement personally, not objectively. I told Eric, that I would gladly give him $75,000 for 51% of his company and I would gladly keep him on as CEO but he would be directed to cut expenses and fire everyone needed so that his current cash flow was positive and he could begin the process of paying down all of the debt including the former partner payout so that he could return from the land of being a charity to that of being an operating company.

He replied that if he were willing to do that, then he wouldn't need the $75,000. Duh! And there's the rub. Is he willing to accept the real nature of his business and live within his real means? Even if it means that he will shrink from his former size, and need to begin the process of rebuilding when and only when the economy allows him to do so.

I have been on the other side of this advice. It was offered by venture capitalists who had invested in my company. The downturn was similar and the reality was the same. I deeply understand the pain of laying off employees and retreating from a perceived victory. And, I also understand how much easier it is to accept the reality when you are not the CEO. In summary, don't try to time comebacks, try to respond to them.

2.4.1 Determining how much you need

But let's quell the rabid former addict's voice for a moment and look a bit more pragmatically at the process of raising funds (God forbid!)

Determining how much you need to raise now is a product of both your pro-forma projections and the anticipated leverage that you will have when future financing becomes necessary.

For example, one school of thought, when raising capital, is to make sure that in the first financing round you raise enough money to get you to cash-flow-positive, thus providing you with leverage when needing to raise additional capital by eliminating the time pressure financial entities often use when negotiating follow-on investments. Once you are cash-flow-positive, you can choose to wait and not take a follow-on investment until the terms are acceptable to you.

Generating a pro-forma P&L and a derived cash-flow projection can shed light on your initial capital needs. It is advisable to make these estimates with highly conservative assumptions about the rate at which revenue will build. In addition, your financial projections can serve as a baseline for measurement of your performance in various areas of running your business and allow you to create corrective actions early. If you choose to raise funds from professional investors, they will require seeing your financial projections which they will use in order understand both whether you are raising the proper amount and what the potential valuation should be.

Alternatively, there are good examples of cases where it might be desirable to choose an alternative plan of raising only enough capital to get you to an important milestone which occurs before achieving a positive cash-flow. For example a smaller first round might be advisable if you are still in the research phase of your business plan and the development of a working prototype or first installation will significantly affect the eagerness with which investors will show interest in your business. The key is the level of leverage that you will have. You will be balancing the advantage of competing investors who want to close quickly versus disadvantage of their natural desire to slow the process down allowing you to run out of cash and become more desperate for funds.

2.4.2 Building Your Pro-forma financials

Your pro-forma financials should consist of three basic sections, a P&L, Balance Sheet and Cash flow. As well, you will want to build a Capitalization table that shows the ownership positions of investors. In my experience of evaluating small and even large companies, I have often relied more on the balance sheet especially when viewed differentially over a period of time. Public market investors are learning the hard way that it has become too simple to cook the P&L in ways that make the performance of the company seem healthy when in fact it is not. Alternatively, if you observe an unusual growth in inventory, or receivables or disproportionate sizes of those for the industry that you are in, then these are sure fire indications of brewing trouble. You should manage your business by managing your balance sheet and internalizing its changes over time.

The key to the design of the P&L is that it is supposed to be a clear and accurate indication of whether the business is making or losing money on a moment by moment basis. As such, start up costs like the build-out of the real estate and capital equipment are amortized and depreciated over their useful life and impact each month evenly as opposed to being taken all when spent. I recommend building your financials from the ground up rather than starting with a template in that it instills a better understanding of the specific nature of your unique business with its relevant assumptions. I would suggest not using plugged in values that are represented as a percentage of revenue in that they are typically misleading for small companies but rather that you build numbers from more actual expected values.

For a startup, the balance sheet yields less important information and the P&L and Cash Flow are more critical. For a startup I would suggest focusing on the short term and building a set of monthly projections for the first year and then annual for years 2 and 3. There are many forms that are typically used for the P&L and the following is one example:

+ Gross Revenue

- Cost of Goods Sold

= Gross Profit

- Marketing and Sales Expenses
- Research & Development Expenses
- General Operating Expenses
- Depreciation Expense

= Net Operating Profit

- Interest and Taxes

= Net Profit

Include both the cost of salaries and benefits and if possible apportioned facilities expenses in each of the departments to which they are assigned. Don't forget that vacation time for your employees may require the hiring of temporary help for part of the year.

Your balance sheet construction typically lists assets and liabilities as shown, with the difference between these representing the stockholders equity (either positive or negative). Changes in the balance sheet over time are the best indicator of a company's relative health.

Assets

+ Cash
+ Inventory
+ Capital Equipment less depreciation
+ Deposits
+ Accounts Receivable

Liabilities

- Loans
- Accounts Payable

= Net Shareholder Equity

The cash flow is a bit more complicated to build because it depends upon when actual cash events occur. For example, if your vendors expect to be paid in 30 days, then the cash impact would be 30 days from the purchase which itself could be 60 days before the goods are sold because of delivery or manufacturing delays. It is best to build the cash flow from the P&L with equations that incorporate the delays expected between payables and their component parts and receivables actual collections. As well, don't forget to include the cash outlays associated with capital expenses and deposits as well as the cash inflows which result from loan advances or the sale of stock. A typical cash flow would appear as follows;

+ Beginning Cash

+ Cash in for loans or sale of stock
+ Cash in for Collections
- Cash out for payables
- Cash out for fixed expenses
- Cash out for capital improvements

= Ending Cash

2.4.3 Determining where to get it

There are many places that one can get money to be used to grow a business. Most entrepreneurs have a natural tendency to try to sell as little stock as possible while raising the needed capital. However, I can tell you from my own experiences, the best of all worlds is to sell no stock at all and find alternative forms of financing. To do this, you've got to start by understanding the food-chain for your product and the value proposition to the food-chain.

As well, there are many instruments that can be used to raise money. The selection of the proper instrument relies upon considerations of ownership, control, incentive, risk and most importantly, the tax implications.

Most often, small companies are started with an initial investment from the entrepreneur or their family. In most cases, this should be placed into the company primarily as a loan. The reason is that when the company generates its first profits, instead of distributing those profits to the owners as either bonus, or worse, dividends, the distributions are simply the repayment of the principal debt which is not taxable to the owner.

Alternatively, if the profits are distributed as a bonus, then the owner will pay income tax on the amount, or if the profit is distributed as a dividend, then both the company and the owner will each independently pay tax on the amount. If there are several contributors, and the initial goal is to in-fact, distribute stock ownership into their hands, then either of two methods can still be used in place of taking the initial capital as the purchase of stock. The first alternative would be to take a small token portion of the initial investment (a few dollars) for the purchase of stock while the majority of the balance is handled as a loan. The initial value of the stock can be set to have nil value by the board. Alternatively, you can issue stock options in place of selling shares. The advantage of the options to the seller is that it does not carry the legal requirements for meetings, voting or the distribution of information that is carried along with stock ownership.

The only rationalization for making the initial investment a capital investment is the issue that a potential lender, like a bank, would prefer to see the capital as backing to their investment. However, the simplest way to accomplish this is to subordinate the investor loans to the bank loans thus providing them with the same level of comfort.

2.4.4 Equity Instruments

If you are determined to sell stock, then there are a number of different instruments that are typically used. These include: common stock, preferred stock and convertible debt.

2.4.4.1 Common Stock

Common stock is what is typically owned by the founders. It is simplest, when selling stock to new investors to sell them an equivalent class of stock, i.e. common, giving them the same proportional voting rights as the founder. In the event of a liquidation or sale of the company, the assets or received value is split among the owners pro-rata to their percentage ownership of the common stock.

Giving common stock to new employees can have adverse tax consequences for the employee. The cash value of the stock would be calculated by the IRS and the income to the employee is taxable. Thus, companies typically use stock options as a method to distribute ownership to employees without adverse tax consequences.

2.4.4.2 Preferred Stock

Often, professional investors are unwilling to make risky investments without some quid-pro-quo of preference for that risk. Typically, this is handled by selling them Preferred shares, a new class of stock. In most cases, the terms are such that in the event that the company achieves a public listing of their stock, then the preferred shares are converted to common shares on a one-for-one basis. It is the "other special preferences" that are often seen as odious to the founder. These typically include: liquidation preference, board representation and piggy back rights. Keep in mind that all terms are negotiable and your leverage in great part depends upon how compelling your business opportunity is. For the most part, for conventional professional venture investment firms, they are less likely to bend significantly and would rather pass on a deal. It is also true that firms from different parts of the country are more or less rigid in their dealings with west coast firms currently being a bit less rigid.

When you create a second class of stock, you must keep in mind that certain events, like liquidation require agreement independently by a majority of the shares of each class. Thus, you may still hold a majority of the total shares, but not really control certain aspects of the company.

Most typically, venture investors will require that they hold one or more board positions, but more importantly, that they control certain board committees such as the compensation committee which will determine the compensation plans for management including salary, bonus and stock options.

Over the years, liquidation preference has become more and more odious to the founder. Typically, liquidation preference implies that in the event of liquidation, the first use of received funds is to pay back the invested value of the preferred stock. Then, once paid, the remaining funds are split pro-rata to the percentage ownership as if the preferred were converted to common shares on a one-for-one basis. Recently, investors have been asking for a multiple applied to the preference. For example, with a 2 X multiple, the first use of received funds would be to pay twice the initial investment back to the preferred owner prior to a pro-rata distribution.

Piggy back rights provide the existing owners with the right to maintain their percentage ownership by participating in new financing rounds at the then-current terms.

2.4.4.3 Convertible Debt

Convertible instruments typically start out as a loan and then convert to some number of pre-negotiated shares usually based upon the unilateral decision of the investor.

It is, of course, possible to create any deal that one can imagine with convoluted conversion formulae which are based upon performance.

2.4.4.4 Stock Options

Stock options are contracts that promise the exchange of stock (usually common) for cash at some future date under the unilateral election by the buyer if they have met the terms of the contract. Typically, the contract requires employment and the terms are to vest a percentage of the ability to purchase over some employment period. The cost of the stock (per share) is stated in the agreement and is typically set by the board to the current value which is nil in the case of most start-ups. From a tax perspective, there is no tax impact of receiving the option (if it is qualified) at the time of the contract. After the option is exercised and stock is purchased, and sold, then, and only then, is a taxable event. Holders of options have no stock privileges such as voting rights or the right to receive corporate financial results or attend stockholders meetings. Thus, stock options can serve as an incentive to employees or other interested parties without negative tax consequences.

Intelligent investors should not be interested in the actual dollar value of a share of stock without simultaneously understanding what percentage of the company it represents since it is simple for the company to change the share value by splitting or merging shares at will. However, reality is that most amateur investors seem unable to comprehend the concept of market cap and percentage ownership and are only impressed with the number of shares and share price. As such, although it is a cynical statement, it is advisable when dealing with employees to adequately split your shares so that it appears that each employee is getting a “large” number of shares without regard to the percentage that it represents. I have always found it bizarre that in general lay-investors who invest in the stock market tend to make this same error in understanding the underlying value of corporate stock.

2.4.4.5 Alternative sources of cash

Some small companies start with an influx of cash from government grants or loans used to stimulate small business or particular fields of research. Typical amounts for initial grants can be as much as $50,000. Unfortunately, the process can be tedious and slow but it can come with very few strings if you can wait for it.

2.4.4.6 The Food-chain

Understanding the food-chain means understanding the flow of product and money that all relies upon your product. For example your: vendors, landlord, distributors, employees and your customers are all part of this network. Each of these parties has a vested interest in the success of your venture. Thus, each can be leveraged into making contributions of time, money or materials in order to benefit their own self interests in the long run. Their individual ability to contribute to your venture is to some extent a function of their ability to afford that contribution as well as their interpretation of the potential value of your success to them.

Keep in mind that if you raise money though the sale of stock, often, that money is used to pay employees or vendors. It might make more sense to consider giving the stock to the vendors or employees in lieu of payment. Then, their continued support and good will is based upon several factors including the desire to make the stock valuable.

One primary goal of financing should be to obtain your financing from parties that have a vested interest in the success of your product and your business in terms that are broader than simply a return on investment from the purchase of stock.

2.4.4.7 Channel Partners

All too often, small companies get wrapped up with other small companies who are willing to listen and spend time with each other. This is generally a real bad idea. If you have a good idea represented by an innovative product and you don't have any money, the last things you need are friends who also don't have any money. It's important that you focus on picking partners both at the level of vendors as well as customers or distributors for whom their financial resources are limitless in comparison to your own. It's kind of like: "I'll bring the product, you bring the money."

2.4.4.8 Customer Financing

The best source of financing is usually the customer that you will sell your product directly to, whether that is the end customer or a reseller. Creative terms for the sale can often provide you with the necessary cash to procure parts, pay employees and build the product that you are trying to deliver.

When selling new innovative products to large companies, especially public ones it's important to understand how they work so that you know what you can ask for. Most large companies are protective of their P&L. As such, they are wary of new expenses for development that would fall under their R&D budget since these subtract directly from profitability. So, asking a large company for funds to finish your development is an idea that most of the time won't fly. In fact, small entrepreneurial companies that are not part of a large company's P&L are a wonderful way for large companies to get R&D done without the impact on their profits. It's a match made in heaven.

Alternatively, selling stock to a large company requires the endorsement of departments that may reach up to the board of directors and clearly reach outside of the sales and/or marketing groups that have expressed interest in your product.

However, there is a solution. While most large companies are protective of their P&L, most have balance sheets with plenty of cash and a total lack of concern about where balance sheet items fall. So, for example, if you ask for a Purchase Order, even for a new, as of yet undeveloped product, along with a deposit, then, the effect on the buying company is of no concern. They simply shift some cash to you and move it from one balance sheet entry: cash, to another: vendor deposits. As well, most department managers have some discretion with respect to signing purchase orders without the need to get ratification up the organization.

The key to being able to obtain financing from your customers in the form of a deposit is to have a value proposition that is strong enough to force them to act. In many cases, this turns out to be some sort of exclusivity either for a territory or a time period that allows your customer to enjoy greater value from your invention.

I've seen many entrepreneurs who are afraid to give up exclusivity. My angle has always been to have it be earned by your customer so that they can actually expand their rights by providing you greater revenue. For example, I might offer exclusivity that increases in scope so long as my customer provided me with the revenues that I felt were appropriate for the value of my invention. Everybody wins.

2.4.4.9 Venture Capital

One of my most famous quotes is that "venture capital is the financing alternative for products with weak value propositions." After all, if there is a strong value proposition, you should be able to get your customer or food-chain partner to finance it with some quid pro quo like exclusivity for some period of time, territory or vertical market usage.

For some types of businesses, however, the only path to success is through obtaining initial capital funding. For example, medical device companies are more likely to need large amounts of capital in order to sustain operations while developing customized manufacturing facilities and while waiting for testing and approval cycles to complete. In the past, software companies would need large amounts of capital as well, in the range of $10M to $15M to sustain long development cycles. However, today, with off-shore software development at markedly lower costs and with more sophisticated tools and distribution channels, software companies can more often bootstrap with less capital, typically in the range of $2M to $3M.

Sometimes, a need to penetrate a market quickly can also drive the need for a large amount of initial capital.

It's important to keep in mind that venture capitalists are assisting your business only to make money. They don't really care about any of the other constituencies that are part of the entrepreneur's life: your customers, your employees, your community, your landlord and your spouse. Their goal is to see a 5X return in 7 to 10 years.

The concept of venture capital requires that venture firms spread their bets over many companies, in fact, too many companies for them to be involved in detail in every investment. Thus, they survive by trading deals and participating in the deals managed more closely by other firms. The net result of this is that *loyalty to other VC firms* is tantamount to their survival and you will always be second fiddle.

A typical venture fund might have $500M in capital and 10 partners. Therefore, each partner is responsible for placing $50M in investments. As a result, venture funds today are not interested in tiny deals of a few hundred thousand dollars and tend instead to focus on deals of several million dollars minimum.

There's nothing wrong with using venture funding so long as you understand the rules of engagement.

2.4.4.10 Types of Venture Firms

There are several different types of venture firms and the models are constantly changing.

Angel investors are usually individuals with private wealth who enjoy the opportunity to either support new entrepreneurs or want to take a personal involvement in their success. Some, therefore, are quite active as investors and want to help, while others simply hand over the money. Individual angel investors frequently require the least objectionable terms of engagement. Typical investments may range from $20,000 to as much as $500,000.

Recently, many angels have grouped together to form angel funds which start to become indistinguishable from smaller Venture funds. Their engagement contracts often are quite similar to venture agreements. Angel funds can typically do larger initial investments which are more similar in size to Early Stage venture funds.

Early Stage Venture funds typically focus on being the first round of investment for young startups. They are often most interested in either a proven team or a strong intellectual property position. Typical investments range from $200,000 to $500,000. The first venture round of financing is often referred to as the "A" round.

Venture firms that focus on "Growth Capital" typically invest several million dollars and do so after the initial product development has been completed and market development phases are entered. These are typically referred to as "B" and "C" rounds.

Once companies move to profitability, they are ready for either "Late Stage" or "Mezzanine" financing in anticipation of a public offering or acquisition in concert with an investment banker. The terms of these investments are typically more attractive to the startup than prior rounds in that risk has been reduced through the demonstration of earnings. The mezzanine funds typically have strong relationships with investment banking firms and can assist with introductions.

Finally, one must also consider that there may be venture arms of corporations (corporate venture) who are participants in your industry. These companies are often motivated to make investments by the potential of gathering market intelligence, getting exposure to key technology or lining up a future acquisition. However, keep in mind that corporate investment from a participant of your industry may exclude the possibility of your being able to do business with companies that are competitors of your investor. In addition, if you choose to accept capital investment from a customer, you will be required to share your company's confidential financial information with your customer, thus giving them an unfair advantage when negotiating pricing. The positive aspect of accepting corporate venture funding is that it is often less sensitive to valuation and offers credibility and potential access to customers or technologies. It is hard to mix both conventional venture funds with corporate investment.

When selecting the venture route, your goal is to build an ever expanding syndicate of stockholders at ever increasing valuations. This is referred to as having "up rounds" where each of your current venture investors participates in future rounds along with new investors at higher valuations, thus endorsing their belief in the new price. Clearly, the ability to increase the valuation relies upon your ability to demonstrate the achievement of key milestones and reducing the risk of the enterprise. The typical milestones include:

- Technical validation of the product concept,
- Customer validation of the salability of the product,
- Business model validation that demonstrates that you can make money selling the product and then finally,
- Achieving cash-flow-positive and thus give yourself the leverage of being able to sustain operations without additional capital unless it is on terms that are acceptable to the current stockholders.

Good venture funds can bring not only capital but financial experience, contacts for sales and hiring and operational experience to the management of a new company. Alternatively, a bad venture investor can bring along with the capital, the disruption of never-ending advice from someone who might be disdainful of management and may have never actually served in an operational role himself. Keep in mind that the "replacement of the CEO" is often seen as the first cure to many growth problems. Thus, carefully selecting your investors is critical to your own success. It's not just the color of their money but you must be wary of the fact that you are bringing on partners and potentially, your new boss when you accept their money.

Refer to the section on "Equity Instruments" to understand some of the typical terms used when selling stock to venture investors. Choosing the venture route will most likely lead to a capital structure where the CEO is left with 6% or less of the company when a liquidity event (a public offering or sale of the company) finally occurs. As well, it is often the case that because of preferred stock liquidation preferences that liquidity events at values less than $100M will not offer any real returns to the founders or management.

2.4.4.11 The Venture Presentation

When making a venture presentation, you must remember that the value proposition is for the stock that you are selling and not for your product. The venture capitalist or any investor, for that matter, is really only interested in how and when they will make money.

This, for example, relates to one of the very first decisions that you made, whether you are building a product or a company. A venture investor is interested in the total market opportunity and how you plan to make your company a major player in a growing market. Alternatively, VCs often may be invest in small/non-existent markets that may either have the potential to grow or may be a stepping stone to larger segments.

An initial venture capital presentation should be no longer than 10 to 12 minutes. In that small amount of time you need to "set the hook" as in fishing by creating a compelling story for which the detail and substantiation can be supplied later. The VC is looking for:

- A large market opportunity,
- A compelling value proposition,
- A competent team and
- Intellectual property that can somehow be protected to prevent competitive threats.

These components are keys to your presentation. The relative importance of the "team" versus the "product" will vary depending upon the specific venture fund.

If I were to use an analogy that your business is a movie and your business plan is the script then your venture presentation is the coming attraction – or theatrical trailer. Most students try to pack too much into their first presentation and try too hard to defend statements that would be taken for granted until proper due diligence is embarked upon.

It is not only the content of your slides that must be concise, but more importantly, the commentary that is presented by you must carry only essential information. For example the statement “my friend is a lawyer and is helping me for free with filing a provisional patent…” should be simply: “our filing of a provisional patent is in process.”

A PowerPoint presentation to a potential investor group should be no more than 15 slides and should cover each of the following points:

- Who am I – A brief introduction to you, your associates at the meeting and your company
- The Problem being solved – There is a problem out there and this is what it is
- The Product – Here’s our product and our Intellectual Property Protection
- The Value Proposition – Why this product is compelling, possibly with a brief competitive matrix
- The Market – its size and geography shows the size of the opportunity
- The Proposed Distribution Strategy – Through what channels and how
- The Team – Who is currently involved, both employees, investors, subcontractors, and why they would likely succeed – for example, prior success and experience
- The Current Status and Short Term Goals
- Pro-forma financials – One page (keep it simple) for 5 years
- Current balance sheet – How much cash and debt do you currently have
- The investment – What they should invest and what you will do with the money
- Conclusion – and how everybody finds liquidity

More detail about any one slide should be available if the investor decides to proceed with due diligence – the investigation of your company and the validation of premises stated in your presentation. Ideally, have hyperlinks that allow you to easily click on a slide to go to substantiation material quickly. The best outcome for you is to complete your presentation and to have them want more information. Then, the next best outcome is to prove that you have done a thorough job of understanding the detailed issues embodied in your business plan.

When you start to schedule venture presentations, start slowly with one or two less likely firms (maybe not focused upon your industry) and use those as an opportunity to tune your presentation based upon the questions and comments received. Be sensitive to the likelihood that there will be common issues across many firms and early feedback can quickly move you to a much tighter presentation. That's why it's also important to bring along a partner who can take notes and record questions and reactions to your presentation. Be careful not to appear to be "shopping the deal" by broadly presenting to too many VCs at once. Finally, I would tend not to use more than one presenter at the first presentation.

Keep in mind that we all are used to advanced quality in media presentations through our saturation by television and movies. Your first impression will consist of not only your clothing, style of speech but also the sophistication of your media presentation. The better you prepare each of these, the more likely you will "set that hook." There are several sophisticated programs like Microsoft "Photo Story" and "Moviemaker" that can be used in addition to "PowerPoint" to add sophistication to your presentation. I know from experience that it is much harder to convert someone from an early bad impression back into a positive frame. Alternatively, building upon a positive initial impression is far simpler. When giving the presentation, speak slowly, pausing after each slide to allow your audience to digest the information.

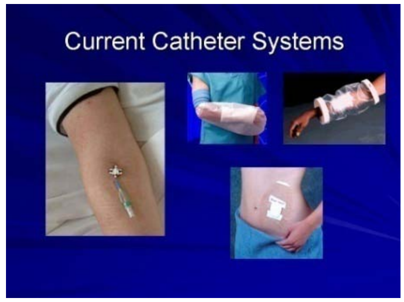
The following table represents a well structured initial venture presentation for a product that was developed in one of my classes by Seth Kudzal. The presentation example should be self explanatory. Developing this type of storyboard will help you in creating the flow for your venture presentation.

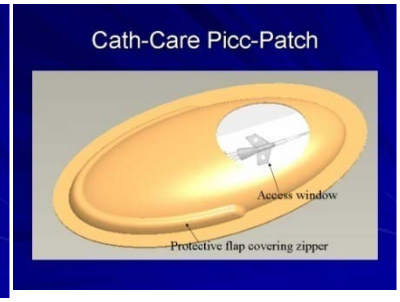
Venture Presentation Story Board

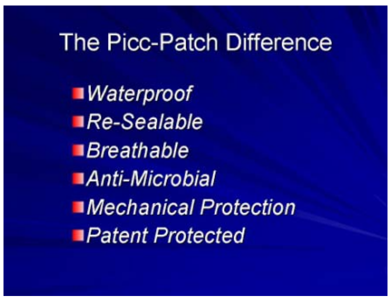
Slide	Commentary
Cath-Care	Good morning. My name is Seth Kudzal. I'm CEO of a new company called Cath-Care and I'm here with my Vice President of Marketing, Melinda Chiou.
Picture of arm with catheter along with other protection devices	Millions of people worldwide are being treated for a myriad of conditions including cancer and renal failure with catheters that are either permanently or semi-permanently attached to a major artery. These patients must live with the discomfort and inconvenience of dealing with this catheter on a day by day basis. A simple shower takes dealing with a variety of contraptions that attempt to keep the wound dry to prevent infection.
Picture of new product	Let me introduce you our first new product at Cath-Care called Picc-Patch which is the world's first re-closable, waterproof bandage for protecting and managing a catheter. A provisional patent is in process and our initial patent research indicates that we have a valuable protected position with this product. In addition, we have thus far determined that there are no regulatory compliance issues for this type of product.
The Picc-Patch Difference Waterproof Re-sealable Breathable Anti-Microbial Mechanical Protection	The Picc-Patch provides mechanical stability to the catheter to prevent pull-outs and tears while also providing a safe waterproof environment that allows the patient to easily shower. The material is Gortex which provides breath ability and there is an anti-microbial agent to prevent possible infection. The Picc- Patch is designed to be worn for up to 4 days.
Market size graph Market Growth graph	Currently, there are approximately 1 million patients in the US who could benefit from this product. Given the average time that a catheter is worn for these patients, there is a total market of 77 million bandage days per year with a compounded growth rate of 20%.
Channel Strategy Direct Marketing Free Samples Major Clinics Longer term OEM	Our initial market penetration strategy is to provide the device for free to major clinics along with documentation necessary to allow the patient to reorder directly from Cath-Care. In the longer term we believe that the catheter manufacturers offer an excellent opportunity for OEM distribution. Currently, the catheter manufacturing industry is $YYB with YY major players. Our product can serve an important role in helping one or more of these manufacturers differentiate their product.

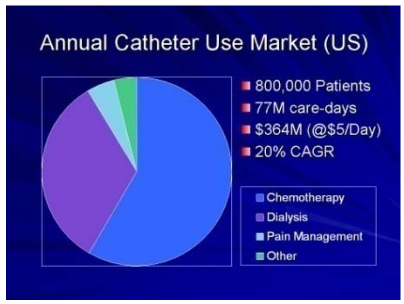
Slide	Commentary
Next Steps: Complete Patent Prototypes Test plan at Hospital Investigate Liability	Our short term plan involves the next critical steps: We are having prototype units built for testing while we complete our patent process. We will be looking to establish a relationship with a leading cancer care provider like Dana Farber or Sloan Kettering for product testing and endorsement. We are interviewing potential Asian manufacturers and establishing pricing. Finally we are further investigating product liability issues.
Team	Our team currently consists of XX with the following titles and experience. We are assembling a board of advisors being led by Dr. X from the Dana Farber Cancer center.
Pro-forma P&L	Here are our estimated revenue forecasts. We see the opportunity to grow this single segment to over $12M in 5 years.
Questions	Thank you. Are there any questions?

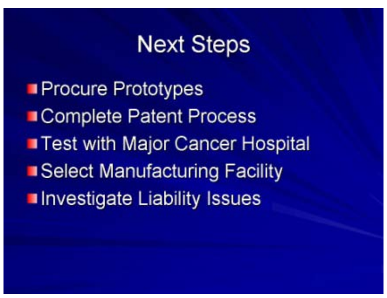
The following were the slides that were developed to this story board:

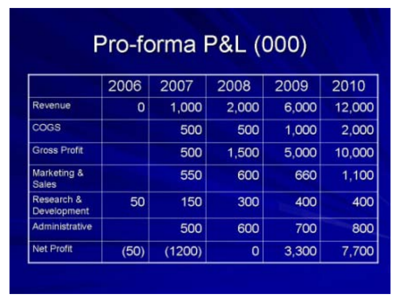












2.4.4.12 Get the Money

The problem that often occurs when raising venture capital is that the truth isn't compelling enough for the investors. So, in essence, they ask you to lie a little and set targets that are a bit more aggressive in order to justify a higher valuation and predict a better return on their investment.

2.4.4.13 Got the Money

This wouldn't be a problem if it wasn't for the good intentions of the entrepreneur. After raising the money, the typical entrepreneur sincerely tries to meet the inflated revenue expectations established during the money raising process. All too often, the growth of revenue can't be forced simply by spending more money, although it sure seems like a good idea at the time. Pretty soon, the cupboard is running bare and the entrepreneur is faced with the unfortunate dilemma of soon running out of money and having to sell more stock.

2.4.4.14 Spent the Money

You can guess what happens the second time you go to the venture community after having not made your initial goals (or lies as the case may be). Now the pound of flesh becomes an entire arm or leg and pretty soon you wind up being an employee at your own company or even worse, an ex-employee.

2.4.4.15 The Power of Positive Cash Flow

Happiness is a positive cash flow. The sooner you get off the addictive nature of spending other people's money and create an entity that is no longer a charity but rather a business, the sooner you have the leverage to decide when you will next choose to raise capital and under what terms.

I cannot emphasize strongly enough that the most important things an entrepreneur can do are:

- Get to profitability or more importantly, a positive cash flow as quickly as possible. That means that you should not spend money on things that you cannot afford.
- Once you get there, stay there. That means, you must shed expenses without haste when revenues fall.

Entrepreneurs would make their selves richer and would even gladden the hearts of their venture investors if they would take a single round of financing and hoard the cash adequately to establish a cash flow positive business and never to return to the venture funding community. Follow-on funding could be obtained at lower cost in the form of debt financing, mezzanine financing or even a public offering.

Thus, while it might be OK to be extraordinarily optimistic about sales projections to get the money, once you've got it, you must manage your business to eliminate the dependency on external capital as quickly as possible.

2.4.4.16 Mortgaging Your House

Are you out of your frigging mind? Most likely, if you're a student, you don't have a house to mortgage anyway. However, it's the principle of the thing. You're using your sweat and talent to build a company and the value of your innovation should be strong enough to get others to finance your dream. If not, find another product where the value proposition is stronger, and return to the concept of having one of your "food-chain" partners finance your venture.

2.5 Leadership Skills

Since most of the students in this course are future CEOs, I thought that I should close with a short note about what your job really entails.

The most important skill of a CEO is communication. The primary job of the CEO is to create a consensus of people who are contributing their efforts, money and time towards a common goal. As the company grows, the circle of "believers" gets larger and larger and the CEO is at the center of the circle. Never flinch. Never show doubt about your conviction that this will succeed and has already succeeded. It's essentially a cheer leader without the pompoms. My list of the qualities of a leader is as follows:

Quality	Interpretation
Integrity	You must maintain an absolute of honesty and integrity in all of your business dealings under all conditions. No exceptions.
Fairness	You must treat your customers, vendors and employees with a fair and balanced approach to the relationship.
Industry	You must lead by example. Be the first to arrive in the morning and the last to leave in the evening.

Decisiveness	As others look to you to make difficult decisions, make them, and more importantly, be willing to change your mind later when compelling evidence demonstrates the past error of your ways. Don't worry endlessly about whether it's right or wrong. After careful consideration, and counsel from your team, make your mind up. You're the boss; you can change your mind later when new information makes the decision clearer.
Communication	Carefully and thoroughly communicate your ideas to your employees, your customers and your vendors. If they don't understand, it's your problem, not theirs.
Rationality	Attempt to make all decisions on the basis of fact and rationality that can be explained and justified to others.
Bravery	Take chances when they seem to you to be prudent. Don't wait for all of the evidence to be visible and thus the opportunities to become stale.
Confidence	Demonstrate to others your conviction in your team's ability to succeed and the value of your product.
Vision	Maintain a vision of where you are carrying your company and coworkers.

I can assure you that there is a considerable amount of fun in building a company. In fact, it's more fun than spending the potential money that you make. Make sure that you take the time to enjoy the process.

2.5.1 Building Your Team

Next, you must surround yourself with people who understand their jobs better than you do. Otherwise, you really don't need them. I would suggest that you wait as long as possible to hire employees. The fixed burn rate associated with building an employee pool is difficult and expensive to shed and should not be taken lightly.

Here are some general guidelines for building a team:

- When you do believe it is time to recruit a position, start by writing a "job specification" that would describe the perfect candidate. Then make sure that you have at least three qualified candidates before you make your selection and finally, check references carefully. It's really hard during an interview to gather a real appreciation of how well a person will meet your needs. I often prefer talking to references who I obtain indirectly from the references given by the applicant. Ideally, it is preferable to hire with some sort of trial period, typically 3 months, after which an evaluation is done and both parties consider whether to move forward.
- If there is any lapse of integrity or honesty on the part of the candidate, do not hire them under any circumstances.
- Always consider the first 90 days of employment as probationary and if you figure out that you made a mistake deal with it and move on.
- Shed unneeded personnel expenses as soon as there is a downturn in your business. Do not wait until you burn through your cash reserve. You can always hire back people later.
- Do not hire relatives, friends or friends of relatives or anyone else for whom discipline would be difficult to accomplish because of personal relationships.
- Always hire too late and shed costs, when there is a downturn in your business, too early. In other words: protect your cash flow first.

Partnerships are a special form of team. In my case I had the good fortune to have three marvelous partners for my second company. The key factor was trust between us. Part of that was their trust in me to be CEO and make the CEO's decisions. A partnership is just like a marriage. You must continue to build and reinforce the trust and value of your partners. You must guard against petty squabbles coming between you. You must trust your partners and they must trust you without reservation. Needless to say, you and they must never violate that trust. My rule is fairly simple: I start pretty much by expecting the best out of people. If they disappoint me due to a lack of skill, it's my duty to help them. If they disappoint me due to a lack of integrity, then it's my duty to end the relationship immediately and not return.

This also applies to your customers and vendors. I have tended in my career to not depend upon lots of legal documents for protection. Rather I've counted on the basic integrity of those I did business with.

It is extraordinarily important that once you learn that a person cannot be trusted that you sever all ties regardless of whether you believe you can outsmart them next time. The words to Cleopatra were: "what did you expect? If you play with snakes you're going to get bit."

2.5.2 Managing Your Employees

When managing your team, you must establish clear ownership and authority for your employees. To do this, you want to create a "contract" with each employee which states what their objectives are with milestones for measurement. Then, at a meeting where you have the opportunity to review their performance to the milestone, you need to create an understanding of whether the time between milestones should be shortened so that they have more guidance during the process. In the best of all cases, you would like to create compensation plans with every employee that is tied to individual performance as well as team performance.

As CEO, I would suggest that you should institute a weekly staff meeting with the heads of each of your departments. At that meeting, you should ask each department head to report on the last week's progress and the next week's objectives. As well, your staff meeting becomes the forum though which interdepartmental issues can be raised and rectified.

Never discipline an employee in public. Allow your employees to learn from their mistakes and grow with the company. Treat your employees with respect and courtesy and expect no less in return.

Common mistakes in management include micro-managing employees and not letting them take ownership for the processes that they are responsible. In general, you should try to limit the number of direct reports to no more than eight.

Keep in mind that every failed employee is a failure as well by their manager. At worst, the selection process needs to be fixed. At best, the failure can lead to modifications in the creation of milestones and objectives that more carefully guides the employee to success.

I strongly urge you to "manage by walking around" so that you are constantly aware on an intuitive level of the workings of your organization on a personal level. As CEO you **must** constantly be visiting customers and employees so that you are constantly aware of where there are problems and opportunities. However, it is also important that you limit your "drive-by-shootings." Keep in mind that anything that you say can influence an employee or your organization in ways that you did not intend because of the weight of your office.

Therefore, you must be extraordinarily careful not to inadvertently change the direction of an employee who is not your direct report.

When managing employees I have had a simple rule: I will accept good news or bad news but never a surprise where the employee knew beforehand but failed to tell me. In general, my process of management works as follows. First, I encourage the employee to establish a goal which, for example, must be met by this coming Friday. Next, I wait for Friday and see what has happened. If the employee met the goal, then I understand that the employee is pretty good at both self management and estimation. I tend therefore to extend the time period until the next goal, thus requiring less management on my part.

Alternatively, if the goal was not met by Friday, then the indication is that this employee is not good at either self regulation or estimation and I shorten the period to the next agreed to goal. Even if the goals shorten to a half day at a time, I continue shortening them until the employee learns to estimate and self regulate. Then, once they are successful at estimating and meeting a goal, I start to extend the time period.

The only unacceptable alternative is that the employee knew that they weren't going to meet the goal, for example, by Wednesday, and failed to let me know. It's impossible for me to do my job if I am operating in a vacuum. Thus, it is essential that an employee never surprise me with information that they had which changed an agreement that we had established before.

2.5.3 Stock Options

A common question is whether and how to use stock to entice employees. First, it depends upon your sense of need to spread ownership of the company to your employee base as a method of obtaining commitment and potentially spreading the benefit of success. More importantly it relates to the need to use stock as a further incentive to bring the desired talent in to a small and somewhat risky operation.

Most typically, stock is used to motivate and attract members of management. The distribution of stock to all employees is completely up to you.

The actual method involves the use of an option agreement (drawn up by your counsel) that sells the stock to the employee at some discounted value upon exercise of the option. Typically the total number of shares that can be purchased is vested (earned) through continuous service to the company. For example, you offer 1000 shares with a linear vesting period of four years pro-rata to the month. Thus after 1 year, 250 shares would be "earned" and could be purchased. Most often, the exercise of the option is left open until either the company is sold, the stock goes public or some fixed time (usually a few months) after the employee terminates their employment.

Keep in mind that options have no voting rights. Only after the stock is purchased does it obtain the privileges of ownership.

The concept of an option was invented to postpone the tax effects to the employee of the purchase until later on when the stock is actually purchased by the employee.

2.5.4 Self Deception

I plead Guilty your honor. This is extraordinarily common amongst entrepreneurs. There's bad news, a problem, a risk, but I just don't want to deal with it right now. So often, I've been in meetings where a small voice has warned me about a problem and I've chosen to ignore it. What can I say? Don't do it. Here is a list of common self-deceptions:

2.5.4.1 It will only be a short downturn

Probably the most dangerous form of self deception deals with recognizing downturns in your business whether they are related to the economy, industry, market, or just you. Your failure to act quickly and adjust your spending rate to meet your real income level will jeopardize your survival. It is hard to fire people, especially when it is through no fault of theirs. However, I cannot emphasize strongly enough, operating at a positive cash flow is essential and maintaining that above all else should be a rule that you live by.

Two of my former student, Brian Hayden and Duncan Miller started a company called Heatspring that provides educational services in the geothermal heating and air conditioning and solar markets. They're growth was excellent over their first year of operation as they built to over a million in revenue and expanded to offer courses throughout the US.

During one of our many meetings, they asked me what might be a prudent amount of cash to build their reserves to and I responded that anywhere from three to six months of operation cash would be nice.

Within several months, they proudly reported that they had succeeded in building the desired cash reserves and even still had enough extra cash to offer bonuses to their employees. The company was still tiny by any measurement with only four full time employees and a number of consulting vendors.

Their analysis of their results after the two years of operations demonstrated continuing growth in what appeared an almost linear fashion. Their confidence grew that they could add staff and double their sales during their third year of operation.

I can recall during one of our conversations warning them that it appeared to me that the economic downturn was going to be deeper than anyone might imagine and to watch out.

Six months later, they had added staff, but the upturn in their business did not materialize and they had burned through the reserves that they had built. The next step was simply their need to survive as they cut staff back to the original four.

There were several lessons that could be learned. First, the reason that one builds a reserve of operating cash is not so that you can extend your lifetime by three to six months, but rather that one believes that it might take that long and that much cash if you react immediately to protect your company. For example, the payment of severance requires cash. Changing strategy requires cash.

The time to act is not after your reserves drop to zero, but literally as soon as the drop below the desired high watermark.

Second, in retrospect it would seem obvious that the worst economic downturn since the great depression might influence one's own business and that you shouldn't take it personally as a sign of weakness or ineptitude. But, even in this case, I know that Brian and Duncan have a difficult time accepting the realities of their dilemma without guilt.

In the end, the inevitable happened. They were forced to shed the expenses and people to whom they promised employment. Their paternalistic tendencies led them to believe that they were responsible for the fates of their employees and the company. Unfortunately, neither is necessarily true or possible.

The key lesson is that one must have the humility to understand that you're not in complete control. As I discussed during in the prior chapter on the random influences on small companies, the principal reality of a small company is that it is tossed violently by its environment; sometimes towards opportunities, and sometimes towards problems. The entrepreneur must accept his or her reality and simply deal with it.

In general, I've always advised small companies that they should "hire late and fire early." By this I mean that they should avoid increasing their expenses as long as possible and cut them quickly when they perceive the earliest indication of a downturn.

In general, it's far easier to add expenses and people than one thinks. But, alternatively, if you die, your dead and resurrection isn't known to work frequently.

One implication of this is that you will experience fear that a competitor will overtake you if the market grows faster than you can serve. In my thirty six years of experience I frankly have not seen this that often. In some cases, for example, in direct television marketing it is somewhat more common for competitors to be hiding in the bushes waiting for the first indication of a successful campaign so that they can knock off the product and enter the fray, but this is the exception, not the rule. And, in general, a cautious entrance into a market along with controlled growth is advisable for small companies given their fragility.

In Brian and Duncan's case, they must continue to look for alternative business models that offer growth, make sure that they return to cash flow neutrality (or growth) as soon as possible and have the patience to ride out the economic storm that they are floating in. From a distance, the absurdity of taking the current downturn personally seems obvious, but when you're on the front lines, it still hurts.

2.5.4.2 He will never figure out that he's making an error

Another popular form of self deception is to underestimate the intelligence of your customer. I have frequently seen entrepreneurs gleefully hoping to sign deals that just didn't make rational sense for their customer. In the end, their customer eventually figured it out and killed the deal, even if it was after signing it. I urge you to attempt to build business relationships on rational basis where you would gladly take either side of the deal. You've all heard the phrase win-win. I hate the phrase, but it's true.

This is especially true when building OEM relationships. One of the keys to this logic is that "you can't win in court" when you have disproportionately smaller resources than your enemy. Thus, you need to avoid confrontations at all costs. In fact, I believe and have frequently suggested to small companies that they walk away from litigation battles and focus instead on finding new and better business models.

2.5.4.3 Two weeks

When you ask an engineer when something will be done, there are only 3 possible answers: it's impossible, two weeks, or it's finished. It seems that two weeks seems like just long enough to finish virtually anything, but it hardly ever is. When you get the Two Week answer, help by breaking down the task into smaller pieces which can be estimated individually. Don't allow any part of the plan to take more than one week to reach a discrete and understandable milestone.

2.5.5 Focus

The nemesis of small companies is lack of focus. There always seems to be too much to do and too many opportunities to chase. The critical discipline that must be encouraged in a small team is to create a list of items that need to be done, and then to prioritize them and start at the top. The tendency is to do the one that is the easiest. The net result being that you feel like you accomplished something, but the critical actions get left undone.

For example, you know that you need to create a marketing plan, create literature and vacuum the carpets. Twenty minutes later, you're carpets are clean and you feel like you've really accomplished something. You've got to learn to leave the carpets for later and focus on the marketing plan until it's done.

The hardest part is: knowing when to give up. Focus and persistence are absolutely necessary in order to succeed. However, sometimes, more than I'd like to admit, we wind up following a defective muse and it then becomes the time to "cut bait."

2.5.6 Leverage

Key to successful business negotiation is to understand leverage. Often the details of how and why two parties are engaging in a business deal are not what they seem to be on the surface. Your ability to successfully negotiate on behalf of your company depends upon understanding both what leverage you have and also what leverage the other side has. It's pointless and often a waste of effort to attempt to get more than you can rightfully expect, it's irresponsible to not take what you are entitled to.

As an example, previously mentioned, at my second company, Leaf Systems, we introduced an innovation for newspaper photographers in the late 1980s. During this time there were considerable competitive pressures between the Associated Press (AP) and UPI, competing wire services. As well, newspapers at that time had lots of profit and 1988 was going to be a big news year in that there were two presidential conventions and campaigns and the Seoul Olympics.

Leaf's innovation was not only viewed by our OEM customer, the AP as a method to make money through resale, nor was it only a method to enhance the productivity of their own photographers, more importantly it was seen as a statement in comparison to UPI about AP's leadership in technology to their customer base. As such, Leaf had extraordinary leverage in its ability to negotiate payment terms (30 days before delivery), and prices (70% Gross Margin) given that the AP's motivations were not heavily weighted to these issues.

Developing a clear understanding of your customer, the industry, competitive pressures, market changes and other attributes of your environment are essential to understanding what leverage you have to make a deal that is particularly favorable for you and your company.

2.6 Conclusion on Entrepreneurship

Starting and running your own business can be extraordinarily rewarding. It can provide you with lifelong friendships and an opportunity to travel the world. Most of all it is simply fun. If you persevere and if you're lucky, maybe you'll make your fortune. But, don't worry about it. It's the making of the money that is where the fun is, not in the spending of it. And, while I'm sure that Bill Gates made more money than I did, I'm not sure that he had any more fun building his company.

"Beter ryk leven dan ryk skerven.[19]"

[19] *Dutch Proverb - "Better a rich life than a rich death"*

3 Marketing and Sales

3.1 Introduction

Marketing and selling is far more difficult and important to the survival of a small company than any other activity. Startups need to begin their engagement with customers as soon as possible; preferably before the product is developed. I present several useful marketing concepts in this book including: category, value, OEM relationships, channel relationships, transaction selling and marketing tools that are essential for the creation of rational marketing strategies.

The term "Marketing" connotes two different processes in most companies: marketing communications (MARCOM) and the development of a market strategy. The marketing department is often responsible for both. The marketing communications problem is large and ongoing and involves the creation of literature, advertising, public relations, trade shows, training and other sales tools. It is often also responsible for the generation of sales leads that will be handed to the sales organization or to resellers for follow-up and closure.

Alternatively, the development of a marketing strategy is yet a larger problem that occurs earlier in the product cycle and dictates how the product and market will meet. By the time a product has matured, most of the investment in a product relates to the cost of the marketing and selling programs as opposed to the product development. Thus, the creation of a rational marketing plan is essential for success. And, conversely, the abandonment of a product for which there exists no rational marketing plan is of essential value to survival.

Much of this Section is focused upon the development of marketing strategy. There will be many examples of marketing communication tools that were developed as a tactical part of implementation, but the process for creation of those tools is not being covered in detail. In most cases, marketing sub-contractors in the form of public relations firms and advertising firms can perform most of the marketing communications tasks external to your organization. However, the essence of the strategy that you will use to build your business is your own problem and the tools presented here hopefully will help you find solutions.

3.1.1 The Fundamental Challenge of Marketing

My definition of Marketing is: the **process** of **communicating** to **eligible customers** a **transaction** along with adequate **value** so as to convince the customer to **buy**.

Unfortunately, it's possible to sell virtually anything. The problem is that many products or services cannot be sold for a profit and there lies the fundamental problem.

For those that play poker, the common wisdom is that the worst hand to hold is second best. This hand encourages the holder to bet on its value even though there will be no return. In the same way, products that have appealing value can lead the entrepreneur into a venture that may not resolve into a profitable business. I've personally experienced quite of few of these cases.

Thus, the fundamental question is not whether it's possible to sell a particular product, but rather, can it be sold for less than the gross profit that it creates.

For example, if I can build a product for one dollar and sell it for ten, then it would appear that I have a nice profitable business with a profit of nine dollars per transaction. However, the problem lies in that sometimes, it costs me nine dollars or more to find a customer, and close the deal and thus every transaction actually loses money.

It is essential to understand the marketing and selling cost per transaction in order to understand whether you have a profitable business. Most businesses fail to reach this understanding.

Later on in this book I describe a tool called the "Transaction P&L" (profit and loss statement) as the "metric" way that you can determine the marketing and selling cost per transaction and attempt to fix it if your current transaction model is too expensive.

Most of my students approach the "cost" of marketing by simply multiplying their expected top line revenue number by, for example, fifteen percent, based upon the assumption that this is a "normal" amount to spend on marketing. My course is based upon a bottom-up approach to understanding the cost of marketing. The Transaction P&L is the compilation of these costs.

It starts with the question of "how much will it cost to "buy" a customer?" Marketing is, after all, the process of buying customers. First you pay to meet them, and then you pay to convince them to make the purchase. The aggregate cost of contacting or finding them, introducing the product, explaining its value, describing the desired transaction and closing the sale all must be paid for with the gross profit that the sale generates. As well, it's important to keep in mind that the cost of approaching and wasting time on potential customers that did not decide to purchase must also be included when calculating the customer acquisition cost.

For example, a student of mine, Rush Hambleton has started a company called Canditto and is attempting to sell a new photographic product to "brides to be." He's found that he can attend small trade shows for around $1000 each in booth costs, plus the cost of labor and travel. As well, he's found that he can hire a fashion model for around $300 to cover the booth for a four hour show. With all of his printing costs, free gifts, and other costs included, the total cost for attending a show can be totaled to around $1500.

He then went to a few such shows (without the model, he did the sales work himself) and proceeded to try to sell his product, which costs around $100 to deliver. He set the initial selling price to $650 and during the show he talked to around 300 potential customers. When the show was done, within a week he had two orders, totaling $1300.

On one hand, his cost per lead was only around $5 (or equivalently, 300 people for $1500) and seemed quite reasonable. But, his cost per acquired customer was thus far $750. Unfortunately, after delivering the product, his gross margin for each sale was only $550 and thus he lost $100 per sale. Clearly, this is not scalable. His challenge is to figure out how to reduce his selling costs to less than $550 and until he does so, he doesn't yet have a business, simply a charity.

Note that in this case it is possible that simply waiting a bit longer until all of the leads resolve into either sales or losses is all that he must do. It may be still too early in his process to clearly understand how many sales were really generated from his trade show investment.

For Rush, the problem is more complicated. Had he charged $200 per product instead of $650, it is possible that he would have closed a significantly higher number of leads. Since all of the selling (and marketing costs) incurred at the show are amortized or spread over all of the sales generated by the show, it is entirely possible that a lower price would yield a significantly more profitable transaction model. In the following table which demonstrates a Transaction P&L, I arbitrarily chose a speculative number of 100 sales at a selling price of $200. (Recently Rush has indeed demonstrated that at a selling price of $200 he closed roughly one third of all leads!)

	Case 1	Case 2
Selling Price Per Product	$650	$200
Leads Generated	300	300
Number Sold	2	100
Total Revenue	$1300	$20,000
Total Product Cost	$200	$10,000
Total Gross Profit	$1,100	$10,000
Total Marketing & Selling Cost for show	$1,500	$1,500
Total Net Profit for the show	($400)	$8,500

Table 1 - Comparison of Profit with fixed Marketing Costs

Clearly, in this example, the key missing fact is "how many leads would I convert into sales at any given price?" For the small business entrepreneur, the method that <u>must</u> be used to answer this is through real experimentation. In other words, Rush must attend a trade show and he must actively experiment with different price points while recording closing ratio at each specific price.

The obvious question raised by students is: "won't my customers discover that my price keeps changing and won't this destroy my credibility?"

The answer is that: "this is one of the costs of doing business." As a small business entrepreneur, you must use read data to drive your decision process. You cannot afford to make a big error. In practical terms, the few customers that you may annoy or confuse when experimenting with price are a small price to pay for the essential data needed to run your business profitably.

For most small entrepreneurial businesses, the cost of marketing is the key to creating a profitable business; however, there are businesses for which the marketing costs are irrelevant. These are typically businesses that have a high ratio of the unit price to the marketing and selling cost. For example, if you're selling jet airplanes, the cost of marketing is likely irrelevant to your profit where in comparison, if you're trying to sell an inexpensive consumer product like and MP3 player, the marketing cost is critical to your success.

3.1.2 How Entrepreneurial Marketing is Different than Big Company Marketing

Most large companies play in pre-existing categories. Their products, for the most part, exist and the companies use small incremental steps of value to attempt to get a share shift from their competitors. Over time, the presence of competition forces the prices down and compresses profits for everyone. This should be self evident, for example, automotive companies build the next “new improved” model of their car, the cereal company also offers a “new improved” product, the razor blade company adds a blade or a vibrator to enhance the performance of their product. Each perceives that they have a brand and opportunities to shift shares within a category by enhancing their current product line.

Each time a new incremental innovation is introduced the opportunity to raise the price is typically taken. The amount that the price can be raised is a function of the perceived added value of the innovation.

Typically, only small increments of value can be easily understood by the customers without substantial additional marketing expense used to educate the customer as to the nature of the incremental value.

For example, a laptop manufacturer might choose to make the next product a little smaller, or lighter, or bigger and brighter but is unlikely going to try to shift their customers from keyboards to tablets in one fell swoop.

Large companies will usually introduce a new “improved” product with incremental value along with a short term media campaign designed to inform the customer about the new value. Unfortunately, the incremental value is necessarily small so that it is easily grasped, and therefore the incremental profit is also small. Thus, the manufacturer will typically lose money until they stop the media campaign with the hope that by that point the customer has been adequately educated about the incremental value and will continue to purchase the improved product. The accompanying figure shows how this might influence a large company’s P&L.

This presents to problems, especially for smaller companies. First, the company needs to be able to sustain the dip in accumulated profit (loss) until the campaign is stopped and the profits can begin to offset the losses. Second, it may occur that a newer product is introduced before the accumulated profit returns to zero and thus actual profit is never realized.

Keep in mind that in most cases, the larger the incremental value, the larger the media cost that is required to adequately teach the customer what the value is. (Assuming that the change in value is not, for example, a fundamental change in one simple attribute in the product that might arise from a technological innovation. For example, if laptops could be reduced to a few ounces without any other change, it would be possible without a big media campaign to have the customer understand and internalize the value.) As I discuss later on, in the extreme case, where the incremental value is very large, one can consider the category as new and not pre-existing and one must use marketing methods that are quite different than those described above. The following graph attempts to illustrate what happens to the P&L when a new innovation is introduced.

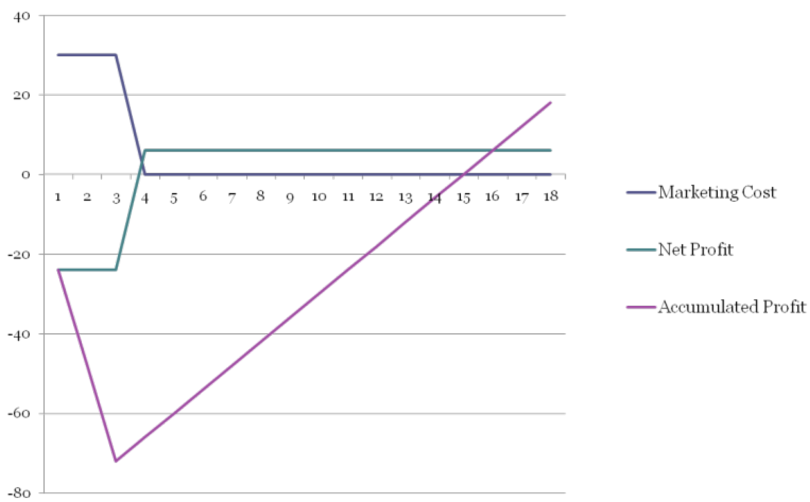


Figure 8 - Product Introduction Cycle

If the incremental value is quite small, then it becomes possible to reduce the media cost to zero for many products and only indicate the added value with proper labeling on the product package in the case of retail distribution. For example, a room air freshener with an outlet on the front might be considered a simple enough innovation that merely seeing the outlet with some large text pointing it out is adequate to get a share shift without a media campaign.

Small companies are typically limited in available capital and cannot afford the risk or cash impact of a large media campaign along with the product introduction. This leaves small companies (without adequate capital to endure the risk or short term losses) four alternatives as to how they can market in an entrepreneurial way.

1. They can use only a small incremental value, as described above, in a pre-existing category and channel and rely upon the product packaging to adequately explain the value. This assumes that the innovation is obvious to the consumer simply upon reading the packaging.
2. They can raise capital and play the game like a large company, that is, use a large media budget and survive through the temporary (hopefully) loses that occur.
3. They can limit their product introduction to a narrow demographic that is easily segregated when purchasing media so as to reduce the cost of the media campaign to a tolerable level. Then with success, the profit gained can pay for expanding the demographic. This could be thought of as taking the curves in figure 1 and breaking it into small saw-tooth steps.
4. They can introduce the product as a New Category and use a direct marketing campaign that has the attribute that transactions are quickly paid for and the media cost is covered by the profit of each sale.

3.1.3 Guerilla and Viral Marketing

Often, students in absence of what I see as a rational marketing strategy will refer to their intended use of guerilla or viral marketing. Here is an opportunity to tie together the first part of this book with the second part in an important way.

First, let me define Viral Marketing. It is believed that all one needs to do is to, for example, post a video on youtube.com or get out on the street and tell some people, so that they can in turn, tell their friends, and so on.

In the simplest Gedanken experiment, “if it was that easy, why does P&G continue to waste their money on conventional advertising?”

In the Entrepreneurship part of this book I used the example of the statistical bias obtained from studying a “room full of lottery winners” as being basically flawed. In the same way, Viral marketing concepts are fundamentally flawed in that they cannot distinguish between those qualities that cause viral campaigns to flop versus those that seem to succeed.

There is no doubt that sometimes it works. But I refuse to count on it working for the success of my company. I must build a repeatable metric that buys customers in a reliable fashion and can be scaled in order to grow my customer base.

3.2 Value Proposition

To Professor Philip Kotler, the S.C. Johnson & Son Distinguished Professor of International Marketing at the Kellogg School of Management at Northwestern University, the value proposition is: "the set of benefits or values a company promises to deliver to consumers to satisfy their needs." To me the Value Proposition answers the simple question: why? Often the answer is not so simple.

Business to business (B2B) Value Propositions are typically described in tangible financial terms, while Business to Consumer (B2C) Value Propositions are frequently less measurable. The Value Proposition is the cornerstone of your business. A weak value proposition will result in the need to be extraordinarily good at every implementation aspect in order to succeed, while a strong Value Proposition can compensate for the marginal execution of various aspects of your business. If you cannot create a clear and strong Value Proposition for your product, for either the end customer or the channel, then you may not want to endure the struggle of pursuing it.

I have seen the tendency in students to create value propositions with lots of intangible values like it's: "good for the environment" or "a better choice." It is essential that you be able to express your value proposition in tangible terms. In the best case, you must actually monetize it and show its real value in dollars.

For example, a strong value proposition for an investment product would be a high return with low risk. For a new furnace it might be a reduction in fuel costs that paid for the furnace in six months. While a weak value proposition might be a new notebook computer with a screen that is 3% bigger. The implication is that the customer has an internal value system that rates the relative attractiveness of the product and its values.

As well, there is a tendency to pile on as many values as possible. I encourage students to try to simplify to, if possible, a single value, for a single additive cost. Additional values can be added later, preferably at additional cost to the customer. If one cannot find a single value that justifies the product purchase on its own, often it is the sign of a weak value proposition.

There are separate Value Propositions needed for the end customer and for the channel partners[20] that you use. Often, the Value Proposition to your channel partner will be more important than the Value Proposition to the end customer. There are many

[20] **Channel Partner** – an entity that buys and resells your product or service

cases where there are large companies competing for market share with virtually identical products. In cases like this, an innovative product, that cannot easily be copied, may represent substantially greater value to existing participants in the channel by allowing them to shift market share for other products that they are currently selling based upon your product.

Thus the specific revenue and profit generated by your product might be a small part of the total Value Proposition when considering the value for the selected channel partners. Note that in these types of cases, striking a deal with one and not all of the channel participants might yield greater value to you. I will discuss this again in the section titled Leverage.

I have seen many examples where a greater Value Proposition for the channel was successful for both business to consumer and business to business cases. For example, back in the 1990s, Olympus had a very strong film camera brand. They were probably the first consumer camera company to use "sex" to sell cameras with a print and TV ad campaign that featured fashion model Cheryl Tiegs using their pocket 35mm camera. With the extraordinary consumer appeal that they generated, they were able to force their retail channel partners (who were typically brick and mortar retailers) to sell Olympus' cameras at a loss simply because they would draw, through aggressive advertising, customers into the store who would then buy other items including batteries and film which were higher margin, but generically equivalent products. This strategy then also made the Olympus camera products have a higher Value Proposition for the consumer by getting the retail price to be lower than competitive products. The net result to Olympus was increased sales and profits.

Figure 9 - Cheryl Tiegs Olympus Ad

It is invaluable to test your proposed Value Propositions with real clients and end customers early in the market development cycle, even before you have finished your product development.

Later on, I will be presenting the concept of Category and emphasizing that it is essential that you determine early in the process whether your product is definSing a new category or is entering the market as part of a pre-existing category. If the Category already exists, then it is essential that you gather a clear understanding of the Values that are currently used by customers within that Category to select products. You must consider either making sure that you meet or exceed the pre-existing values already established in the market with the addition of your new value, or you must fight the difficult battle of convincing customers to abandon their prior value system in favor of your unique proposition.

A good example of this was faced by TiVo when they launched their new digital recorder. They decided to launch it as part of a pre-existing category – that of VCRs. Back in 1999 when consumers were attempting to select between various VCR offerings, they assumed as a necessary value, that they would be able to play prerecorded video tapes obtained at a rental store. Unfortunately for TiVo, their product did not have a way to play prerecorded VCR tapes and didn't therefore meet a basic value expressed in the category. Therefore, they were asking consumers to forego their original value system in favor of new values offered by TiVo in their attempt to share-shift the customer's purchase to their product. This strategy was not successful.

3.2.1 Business to Business Value Propositions

Most business to business (B2B) value propositions consist of a statement about either making or saving your customer money. The precise amount that can be saved or made is compared to the cost of the product. In general, for products that make money, one considers the payback period for ownership. Or, equivalently, how long must I own the product to pay for the acquisition costs with profits generated by ownership. Payback periods of less than one year are often considered attractive by the purchasing company because of the way that we report financial information and pay taxes in the US. This is true unless the product purchased is an asset that can be capitalized and amortized over several years. Otherwise its cost impact is taken entirely in the year of purchase and the reduction in profit will be considered unattractive by the buyer. The larger the company, the less likely the CEO will be willing to explain to the stockholders why profitability has gone down but is expected to rise later on.

Alternatively, when buying a product to save money, the same consideration is made when comparing the cost of acquisition to the cost savings per year. Again, a payback of less than one year is considered attractive.

In general, my experience is that it is easier to sell products that create revenue opportunities for your customers than it is to sell products that save them money. The reason is because it is easier to find an internal champion who is usually in the marketing or sales department or the CEO who fosters your product though their internal decision processes. This is because the sales and marketing groups are generally measured on their achieving revenue and profit targets while it is difficult to identify someone who is measured on cost reduction targets.

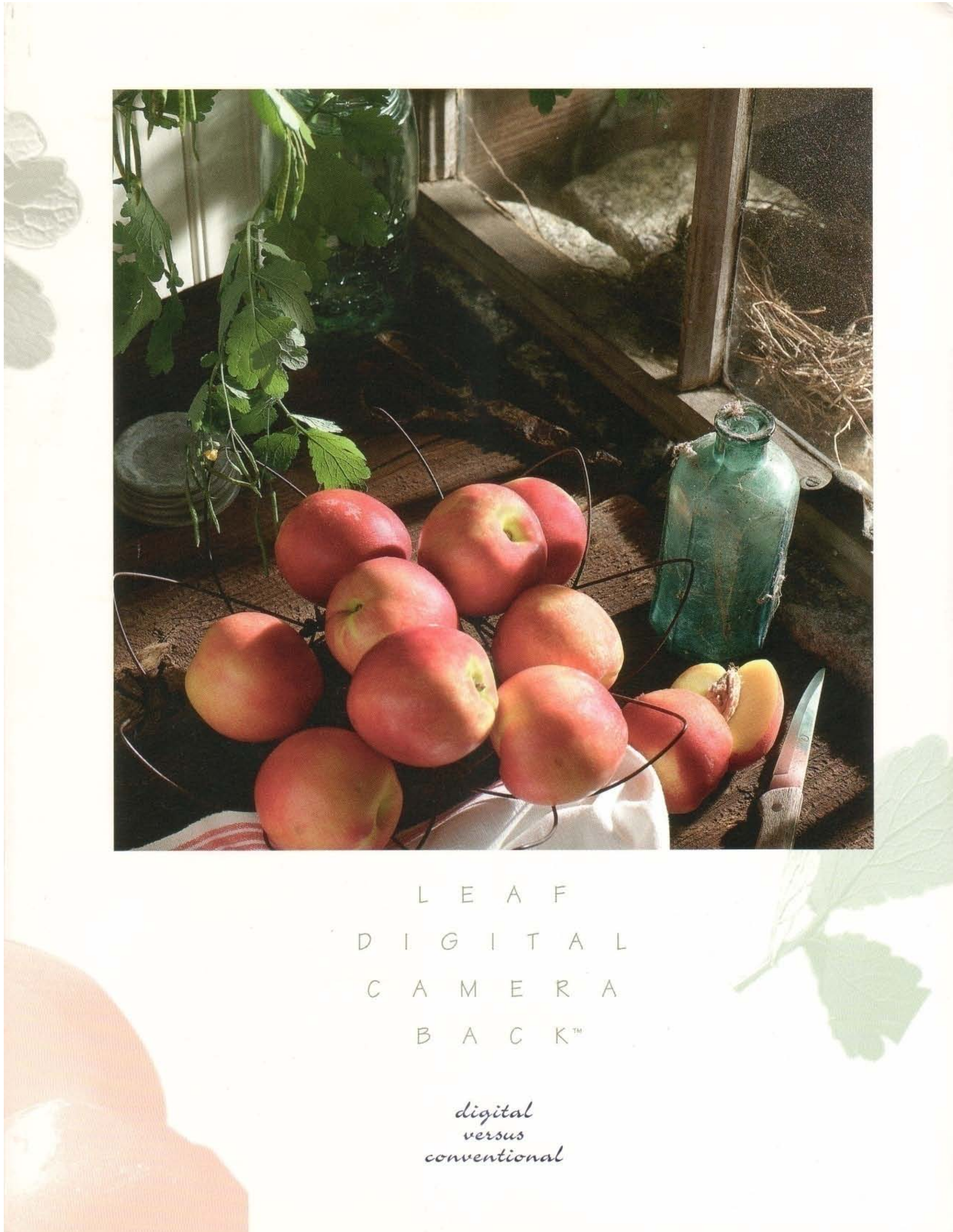
For example, in my first company, CDA, we found that hospitals were eager to add CAT scanners and MRI scanners to their facilities because they could add revenue (a key factor being that the scans themselves were approved for reimbursement by third-party payers – insurance companies). Alternatively, PACS systems (Picture archival systems) which could save hospitals millions of dollars of storage and retrieval costs were a significantly more difficult sale at first.

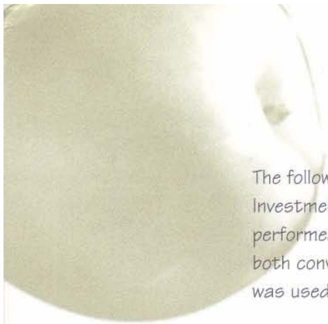
Some business to business value propositions are less tangible and help the buyer with the ease of their business process or intend to help with revenue generation but in a less measurable way (for example, the redesign of a logo). These are also difficult sales.

Often, there are many additional attributes of a product acquisition that are central to its value. For example, your customer is considering their own relationships with their own customers and their own competitive positioning with and without your product. These may be less tangible but more important issues when they are considering the purchase.

There are two examples found in my second company, Leaf Systems. In the first example, we introduced one of the world's first digital cameras for professional users. The camera costs roughly $35,000 and also required an investment of another $10,000 for related computer equipment. Leaf did a careful analysis of the costs and profit of film photography for the professional photographer. Then, in comparison, Leaf did an analysis of the profits when switching to a digital workflow. The value proposition offered additional revenue, lower risk, less cost and faster job cycles to the photographer. *Unfortunately, the sale was made more difficult by the fact that most commercial photographers were relatively small businesses and a $45,000 purchase would be their second largest acquisition after their home.*

Nonetheless, Leaf was successful at moving photographers from conventional film to digital imaging through these value propositions. The following pages are a promotional piece that we used to introduce the value proposition to the photographer. We created these by giving cameras to early adopters in exchange for allowing us to carefully study and document their costs and profits before and after switching to a digital workflow. This testimonial data became our monetized value proposition explained in our literature with carefully constructed before and after workflow comparisons.


LEAF
DIGITAL
CAMERA
BACK™
digital
versus
conventional



Digital versus Conventional

The following is a Benchmark Study and Worksheet to help determine Return on Investment (ROI) when purchasing a Leaf Digital Camera Back. The test was performed at Ulsaker Studios in Hartford, Connecticut. The same setup was used for both conventional and digital photography workflows. The following configuration was used for this test:

Conventional Workflow
- *Hasselblad Camera*
- *Macintosh Quadra™ Computer*
- *Smart 340 Scanner*
- *Iris SmartJet 4012*
- *Magneto Optical Drive*

Digital Workflow
- *Hasselblad Camera*
- *Leaf Digital Camera Back*
- *Macintosh Quadra Computer*
- *Dye-sub Proofer*
- *Magneto Optical Drive*

Features

Leaf Digital Camera Back
- Attaches directly to several medium format camera bodies
- Supports strobe or daylight lighting
- No chemical and film disposal
- Dynamic range of 10,000:1

Benefits

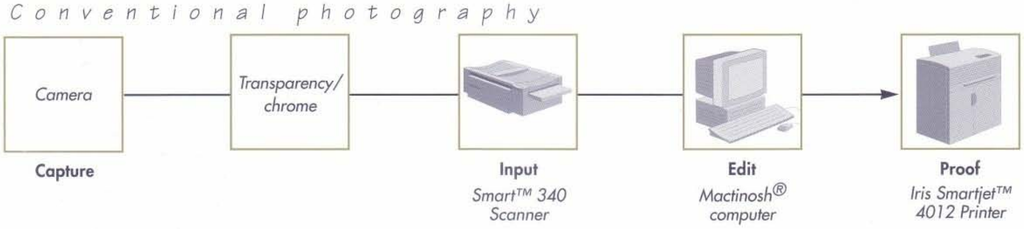
Leaf Digital Camera Back
- Works with Industry Standard Cameras- requires no modification
- No Custom Lighting is required
- Environmentally safe
- Equivalent to over10 f-stops

Benchmark time results

Job Times (Hours/Mins/Secs)

Task	Conventional	Leaf Digital Camera Back
Load magazine	00:00:50	na
Shoot Polaroid® instant film tests (6)	00:01:30	na
Bracket conventional film exposures (6)	00:01:15	na
Process film	01:00:00	na
Capture image	na	00:01:10
Scan chrome	00:02:30	na
Save as TIFF	na	00:00::23
Export and open	na	00:01::08
Sharpen in Adobe Photoshop™	na	00:00:23
Proof	00:03:26	00:12:00
Save to optical disk	00:02:30	00:02:30
Total time	**01:08:34**	**00:17:34**

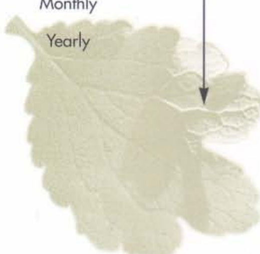
Conventional photography



STA 8/94 Printed in the USA

ROI

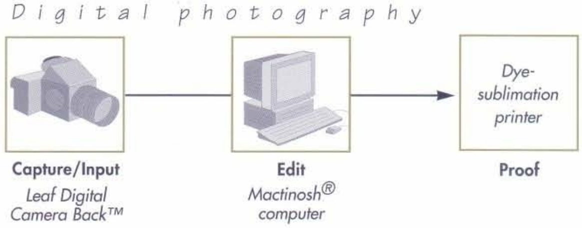
Supplies and Services	Volume	Unit Cost	Total Cost Factor	Total Savings
Photographic Supplies: film and processing				
Cost of film	6 exposures (avg.)	$0.40	$0.40	$2.40
Film processing	1/2 roll	2.50	2.50	2.50
Polaroids	6 exposures (avg.)	1.50	1.50	9.00
Per Shot Total =				**13.90**
Shots per day	6 setups	13.90	13.90	83.40
Shots per month	120 shots	13.90	13.90	1,668.00
Shots per year	1440 shots	13.90	13.90	20,016.00
Color Separations				
Daily	6 scans	60.00	60.00	360.00
Monthly	120 scans	60.00	60.00	7,200.00
Yearly	1440 scans	60.00	60.00	86,400.00



Annual Savings *Supplies and Services*	$106,416.00
Leaf Digital Camera Back & Macintosh	$50,000.00
TOTAL ANNUAL SAVINGS	$56,416.00

Scitex America Corp.
Eight Oak Park Drive
Bedford, MA 01730
Tel: 617-275-5150
Fax: 617-275-3430

Digital photography



Keep in mind that if your product is sold through layers of distribution, then the value to each and every layer must be independently stated and quantified. It is not adequate to only state the value to the end customer. Single products must have multiple value propositions depending upon who the target of the immediate sale is.

Often, the quantification of value can only occur after you actually sell (or give away) your first products and then study your customers to see what they made or saved as a result of using your product. Thus, pricing will often be adjusted as you better understand the actual value of your product to your customer.

When pursuing a public relations campaign, you will often want to place testimonial articles written by satisfied users into trade journals read by their counterparts. Early customers who are closely studied can contribute by being the authors of these articles. The reality is that the articles are actually written by the vendor (or by a subcontractor to the vendor) and then submitted to the magazine under the name of the customer. The customer will appreciate the opportunity to get exposure to their industry and acclaim as a technical leader.

AP-Leafax-35

The second Leaf example was our portable film scanner and transmitter, the Leafax-35 which was sold to newspaper and wire service photographers for the purpose of sending photographs that were collected on field assignments back to their home offices. The Leafax-35 was introduced in 1988 at which time newspaper photographers on field assignments would literally need to set up a portable darkroom to develop film and make prints for transmission back to their home office on a drum facsimile system developed back in the 1940s. With the Leafax-35, the photographer still needed to develop the film, but the print making step could be eliminated by scanning, editing and transmitting directly from the film. To the end-customer, the primary value of the Leafax-35 was the ability to send photos that were captured later and therefore closer to press time. For newspapers and wire services that were competing to submit late breaking news in time for inclusion in the evening press run, minutes of time-savings were invaluable. This

Facsimile Drum Transmitter

was especially true in light of many sports images that are collected at evening games.

To the particular newspaper the ability to include a late breaking photo that was not available to competing papers held extraordinary value in potentially effecting circulation and thus directly influencing advertising revenue. As a result, the Leafax-35 was adopted by the industry quickly even at a cost of $20,000 each. Customers never asked us to monetize the value, nor was it necessary.

3.2.2 Consumer Value Propositions

Consumer value propositions are significantly less clear. One can consider consumer spending to be made of two principal components: necessities and junk. For purchases of necessities like food and fuel oil, value propositions are often as tangible as those found in B2B cases, emphasizing quality versus price. However, most consumers' spending is for non-essentials, and is effectively the use of disposable dollars after meeting one's essential needs.

As a result, virtually all consumer products compete with all other consumer products whether they share a common category or not. Would you rather have the vacation in the Caribbean or the new car?

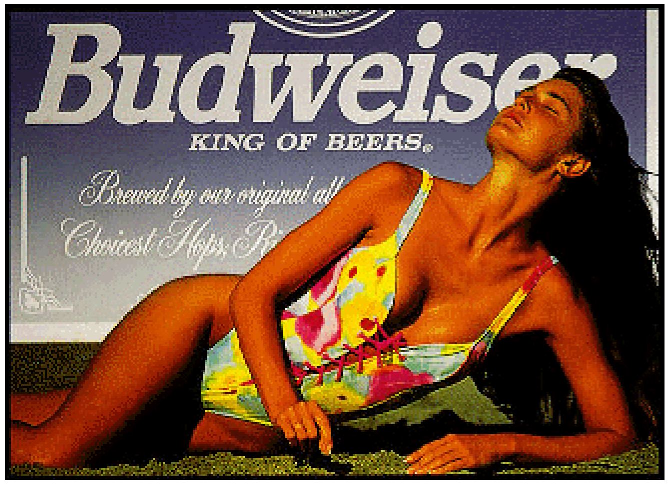


Figure 10 - Budweiser Corporation Ad

Marketers of consumer products understand that they are therefore marketing to the consumer's most basic desires: beauty, sex, popularity, etc. Advertising and the development of value propositions are often mired in innuendo relating the product to, in some cases, primal instincts through absurd logic. Drink beer, get popular, have sex.

These underlying factors are probably the root cause for the success of marketing concepts like "The Reptilian Brain" developed by French marketing genius Clotaire Rapaille. An excellent review of his concept can be found in a Frontline article available on the Web.

Figure 11 - Clotaire Rapaille (Frontline image)

Rapaille attempts to define the primal urges that cause consumers to make brand and feature selections and he believes that these can be understood and appealed to subliminally.

In most cases, category advertising creates a basic want for a product category. Sometimes, like in the case of Bright Smile a teeth whitening service business, their extraordinary investment in building the category – i.e. "get whiter teeth, get popular, have sex," didn't simply build their own sales but rather, built the desire for the entire category which included a myriad of teeth whitening products ranging from toothpaste to dental bleach and appliances. The net result was that their business was losing money due to the dilemma that their high cost of advertising was not being paid for by their sales level and, the rest of the tooth whitening industry was, I'm sure, grateful.

In all likelihood, new entrants to previously established consumer categories don't need to build a general desire for the category, but rather can focus on share-shifting within the category. In established categories, consumers will often buy on the basis of brand confidence. Moving consumers off of established brands often requires considerable pressure of price or innovative difference. For years, Chinese manufacturing companies have been sole source providers of countless different brands where the insides are literally identical. The branded product continues to survive in the market even though it is sold at a higher price. This is especially evident in clothing, luggage and electronics.

Before the advent of flat screen TVs, there was in fact only one manufacturer left in Asia of televisions. Every brand, whether RCA, or Pioneer was made by the same company. The same was true for portable CD players. I can recall visiting their facility and being surrounded in the showroom by every imaginable brand.

Often, manufacturers will attempt to sway consumer preference and/or action with a gift. These are called "Premium" products (not to be confused with the typical use of premium as implying "of higher quality." It is interesting to note that the most successful Premiums are those that have the maximum difference between perceived value and actual manufacturing cost. For years, this has included clothing and luggage where excessive brand advertising has built a perception of disproportionately high consumer value.

3.2.3 Competition

It is essential that as part of creating your value proposition that you create an understanding of your competition. After all, value is a relative term and is most often relative to competitive products. Studying your competition can also teach you about your channel, distribution alternatives, market size and most importantly it can help you to create a model for what your business might look like in a few years. Studying their financials and their advertising will show you what they have learned and what errors they have made. Here are some points to observe:

1. What channels do they sell through?
2. What distributors or sales reps do they use?

3. What is their pricing?
4. What are their product features?
5. What does their packaging look like and why?
6. How much product do they sell and where?
7. How often have they updated their product?
8. Where do they advertise and how much?
9. Where have they tried advertising and stopped?

Often, channel partners who handle their products are willing to share information as are advertising sales people who work for media that they use. As well, studying serial numbers can help you understand the volume.

It's wise to start with the assumption that they probably aren't stupid and that if they are doing something now, for example, advertising in a specific journal, it's because it works and if they are not selling to a specific customer base it's because it doesn't work. I'm not trying to imply that there isn't room for innovation in these aspects of building a business but all too often there is important and valuable information in the methods and success of your competition.

Part of your marketing plan should include the creation of a competitive matrix which compares your product to those of your competition. A sample matrix is shown below. Of course, the column and row headings, and the number of columns and rows is specific to any category.

	Price	**Speed**	**Weight**
Your Product	$500	55	15
Competitor A	$650	55	15
Competitor B	$900	60	12

Figure 12 - Competitive Matrix

It is essential that as part of building a competitive comparison matrix that you identify the values that customers currently use when making a selection within your category. As well, you want to emphasize for your customers where you have leadership in value. The competitive matrix should become part of your brochure, customer and channel presentations.

3.3 Category

Once you have created a clear Value Proposition for a product, next, you should define the Category for the product. **Properly defining the category for your new product is essential to gaining an understanding of how to approach the market.** In general, I would segment products into two basic groups: those that define New Categories and those that are members of Pre-existing Categories. As I will elaborate, in general, new category products do not do well in channels that are optimized for pre-existing categories. Alternatively, pre-existing category Products cannot achieve the profit necessary to support distribution through channels optimized for new category products.

A few simple tests can be used to determine which group a product belongs to. Pre-existing category products are products for which any of the following are true:

- For Retail Distribution, there is a clear and unambiguous place on an existing shelf within current stores that this product should be positioned.
- For business-to-business sales, there are currently purchase orders being written for competing products that could be converted to this product.
- There are clearly competitive products that are established and are successfully being sold in the current market.
- For many service businesses, the existence of a "Yellow Pages" category

There is not always a single answer for every product. For example in many cases, a product can be conceived of as either a member of a pre-existing category or as defining a new category. A good example is TiVo where the company originally attempted to launch it as part of a pre-existing category: VCR recorders. Unfortunately, TiVo did not meet some of the essential values of the category (as described in the Value Proposition section) including the ability to play prerecorded VCR rental tapes which made it an especially difficult purchase decision for consumers who were looking for a VCR. Alternatively, TiVo could have been launched as a New Category – Digital Video Recorder, which would have implied making channel decisions that were consistent with the needs of a new category product. In all likelihood, the TV infomercial channel of direct marketing with celebrity endorsement of the product would probably have worked quite well for TiVo in place of their retail brick & Mortar channel strategy.

Thus, the essential question is not whether your product is a New or Pre-existing Category product, but rather: which strategy holds the most likely promise of success? In general, new category products are more difficult to launch because they require the building of an entire value system in the customer's mind while successful share-shifting strategies in pre-existing categories offer less risk and more rapid routes to revenue because the amount of information that must be successfully transferred to the customer is by definition limited.

3.3.1 B2B Categories

For B2B businesses, the classification of category is equally important. Pre-existing categories will have established channels for distribution, competitive value structures, media usage for advertising and inherent understandings of the product established in the user base. Alternatively, new category products will need to establish methods for distribution that educate the customers as to their value.

For example CAT Scanners compete with other CAT Scanners and have values of cost, speed, resolution, dosage, size, etc. Radiologists will have value systems that pre-exist the introduction of a new product. They will read specific journals that will inform them of new products and innovations within the category.

A new modality, for example a thermal scanner, for which there was no inherent understanding within the customer base, would require building a value system, for example, in the medical industry through the use of clinical test data and testimonials.

3.3.2 New Category

New category products are products for which the customer does not have an intrinsic understanding of the product's value or the channel that should be used for its purchase. As such, they need channels that support a larger amount of information transfer to the potential customer. These uniquely information rich channels include:

- Direct marketing channels on a variety of media including:
    - Print, TV, Radio, Direct Mail, Internet
    - Direct selling by sales reps (most likely for B2B)
- Some catalogs like Sharper Image
- Multi-tier marketing organizations
- Web sites

Another alternative, not usually available to small companies because of its cost, is to invest heavily in product advertising to build customer awareness of the new category. There are many cases where large companies choose this alternative even though if they were to analyze the profitability of the product over the short term it would be a dismal failure. Still, they are often willing to accept the losses for the purpose of building a new category along with their brand.

Note that retail channels require a sell-through that justifies the use of shelf space which could alternatively be used for some other, better selling, product. As such, retailers in general have very little patience waiting for a brand's advertising campaign to obtain adequate traction through education of the masses to the value of a new category product. Only large brand manufacturers with substantial leverage over retailers can pressure retailers to preserve shelf space for new category products while they build product awareness with a broad and often expensive advertising campaign.

3.3.2.1 New Category, New Channel and New Use

Frequently, I have been presented with a business plan that contained both the invention of a new product and the creation of a new channel for distribution and even in some cases a new vertical market that uses the product. Unfortunately, it's a tough way to build a business.

For example, a student proposed that in Mexico there are not retail outlets that sell stylish clothing for young girls. There are clothing stores, and there are products for young girls, but neither is very good. She proposed opening a new retail store and importing (or designing) a new line of clothing for the store.

I suggested to her that the problem of creating a new brand of clothing was itself a hard problem. You needed to find designs, engage with manufacturers, import the products, deal with returns, etc. And, as well, being a good retailer was a different hard problem. You needed to make sure that the store was clean and efficient, that the employees were honest and hard working, the products and location were well selected, etc.

Being especially good at two businesses was twice as hard as one and more than twice as likely to fail. Imagine if she picked a bad retail location but had perfect products. She could still fail.

As well, if she focused on just one of the two businesses, she might find a better partner (than herself) for the other part. For example, if she focused on the importation of stylish clothing for young girls, then she could attempt to sell it through every clothing store in Mexico and have a substantially larger opportunity.

It is essential that when starting, one must pick one thing to focus on and be the best at.

For cases where the entrepreneur has two dissimilar tasks: the development of a product, and the development of a use for the product, or the distribution of the product, these often require different skills and organizations. It becomes a distraction to the management team to figure out where to focus their efforts and resources; towards the improvement of the product, or towards the development of the vertical use.

Worse, these types of companies are often limited in their growth by the organic growth and acceptance of the vertical application. All too often, these companies don't have the staying power to wait for this organic growth to occur.

I have frequently been pitched new vertical market applications that didn't even exist yet, but, according to the entrepreneur, would be born and grow rapidly because of the introduction of a new product or technology.

Unfortunately, that isn't the way it really works. What one will tend to find instead is that most vertical markets have price and convenience penetration curves that are asymptotic. Without the new "invention" it should be possible to still demonstrate the existence of a vertical use market albeit small, limited by the cost or inconvenience of the current solutions that are available. Then, one should be able to demonstrate that technical innovation causes the growth of the market by reducing the cost and inconvenience.

Alternatively, if one proposes that a new vertical market will grow from non-existence with the creation of a new product, I tend to generally find it unconvincing. In fact, most often, technology causes the shift in cost/performance of existing use models that grow the acceptance but do not change the basic concept of the vertical market use.

3.3.3 Pre-existing Categories

If the category already exists and your product must be competitively positioned against alternatives, your marketing tasks will be greatly simplified. This is assuming, of course, that your product has some advantage over the competition. Your goal is to cause a "Share-Shift" from established products in the category to your own by highlighting your innovation whether it's price or an enhancement in performance. The essential quality of a pre-existing category is that the customer has a channel in mind as the method for finding the product and it's simply too expensive and not efficient in most cases to attempt to meet the customer somewhere other than where they are expecting to find the category. Therefore the battlefield is set for most "in category" marketing to be the shelf where the category is sold. The following is a good example of an innovation within an existing category.

THE GOODS

BRENDAN I. KOERNER

Never Lose A Corn Holder Again

Tony Cenicola/The New York Times

HOW is a corn holder like a sock? No, this is not the first line of an absurdist joke. The serious answer, courtesy of the product development team at Zyliss USA, a kitchen tools maker, is that neither item is useful on its own. Just as socks come in pairs, so too must corn holders; lifting a cob with a single holder can end only in frustration.

The similarities don't end there. Socks often vanish in the tumble dryer; corn holders tend to go mysteriously astray during the journey from picnic table back to the utensil drawer. To make matters worse, according to Patrice Gerber, Zyliss USA's director of worldwide product development, searching for a misplaced holder can be painful — literally. "Corn holders are pretty sharp at the tip," Mr. Gerber said. "If you go fumbling around your drawer looking for one of these, you might hurt yourself."

Errant holders and impaled fingers are less of a concern with Zyliss USA's interlocking corn holders. They can be snapped together when not in use, concealing their potentially injurious parts. The prongs of each holder slide into holes bored into the other; only the rounded plastic grips are thus exposed.

The interlocking holders, which cost $4.99 for a pack of four sets, are what Zyliss USA, which is based in Foothill Ranch, Calif., calls a "flanking product" — an inexpensive item intended for impulse buying. These differ from what the company calls its "pillar products," like the Easy Spin Salad Spinner. Flanking products, Mr. Gerber said, are somewhat like advertisements. "They're so everybody can get their hands on a Zyliss product," he said, "and get excited with our brand."

How to tame a hazard in the kitchen drawers.

The corn holders were just one of dozens of ideas that Mr. Gerber's team presented to Ideo, a product design firm in Palo Alto, Calif., in late 2003. Mr. Gerber recalled his surprise at the enthusiastic response of Ideo's engineers, who quickly put together some prototypes for Zyliss USA, a subsidiary of the kitchenware manufacturer Zyliss A.G. of Lyss, Switzerland. "We looked at them and said, 'How simple, yet so cool,'" Mr. Gerber said.

Though a corn holder is an exceedingly simple device, completion of the product's design still took three to four months. One major concern that Zyliss USA raised with Ideo was whether the holes for the interlocking prongs were too narrow to clean and might therefore become clogged with corn detritus after repeated use. The solution was to bore the holes clear through the plastic grips. The prong tips are even visible when a set is latched together, but when you detach them for cleaning, dishwasher suds are able to sluice through the holes and rid them of niblet specks, Mr. Gerber said.

Zyliss USA enlisted the aid of several in-house, corn-loving employees to test the holders. The volunteers were instructed to use the holders at home, and to pay particular attention to whether the plastic grips could be rotated easily between thumb and fingers while eating. Their reviews were positive enough to convince Zyliss USA to bring the product to market; it has been available at retailers such as Crate & Barrel since April 2004.

Mr. Gerber says that many parents have praised the product, not only because it lessens the chances of a painful poke, but also because it provides entertainment value. "It's a little bit of a toy," he said. "You have it in your hands, and you have to pull it apart and then put it together."

In this way, too, corn holders are rather like socks. Anyone who has ever turned a tube sock into a cheerful puppet can attest to that.

Figure 13 - New York Times Article on Innovation

This article in August 14, 2005 Sunday NY Times highlights an innovation in the category of "corn holders." The improved version is harder to lose and safer to store. Note the excellent PR obtained through the innovation. Also note the product testing done somewhat casually within the organization.

This development was done by IDEO, which is an interesting example of a company that is focused upon in-category innovation.

Within a category, innovation tends to cause share-shifting. **Competitors will usually respond with their own innovation or, more likely, with a change in price to attempt to shift share back.** Modifying price can obviously be done more quickly until an alternative innovation can be brought to market. Key to innovation within a category is the ability to express the value of the innovation to the buyer quickly, often only through the packaging, so that they can move their purchase decision based upon your improved value proposition.

When one considers product life cycles at the macro level, at the micro level one is observing this dance of share shifting and the resulting reduction in price, margin and the introduction of new improved versions.

In-category innovation is the mainstay of all product companies. It is the method used to constantly attempt to incrementally shift customers to their products, in some cases, away from prior models of the same company. Probably the most common example of in-category innovation being used for share-shifting is in the razor blade industry. Over the last few decades we have seen the development of: The safety razor, the disposable safety razor, the 2 blade razor, the 3 blade razor, the 3 blade with vibrator safety razor and now the 5 blade razor available either with our without a vibrator. Yet all of these are clearly in the same category and are easily understood for their intrinsic value.

Note several observations from the razor blade industry. First, increments are kept small. It's not that they couldn't think of a three bladed razor when the market only had one blade; it was that there would be no additional share shift obtained from bringing three blades to the market too quickly. And, the increase in manufacturing cost and reduction in margin from a three bladed product suggest that two blades is enough for now, and three blades will be used later, after the competitors respond.

Second, the implication is that to the customer, there is no difference between two and three blades if the current market only has one. To get share shift one only needs to be better than the competition. In fact, moving too far from the current norm might actually turn off customers since they start to perceive the product as a "new category" and do not internalize the value of being so different.

When working in a pre-existing category it is essential that you learn what the current values are upon which customers make selections within the category. Then, it is important that you meet the existing criteria for selection with the addition of your innovation as opposed to offering your innovation in place of the currently valued product features.

For example, one of the students in the class of 2005 had a new type of candle holder that added better fragrance diffusion and automatic extinguishing of the candle after a preset time. The pre-existing category of decorative candle holders was defined by aesthetic attributes which identified different products within the category. Some had appealing color, others a unique design along with their functional description of being a candle holder. Preferably, the new entrant would need to meet the aesthetic requirements of the customer selection while adding the new features in order to compellingly shift buyer share to their product. It would be harder to successfully shift customers to the new product if one, instead, offered a poor aesthetic design while adding the new features.

Retail package design that highlights the in-category innovation is essential for creating the customer awareness necessary for share-shifting.

Another good example of some of the problems that can be encountered when entering a pre-existing category was Erox. Erox developed a new, patented additive which was a human pheromone and could cause subliminal effects when smelled. They elected to enter the perfume category with a new scent called "Realm" which contained these chemicals. Erox failed to recognize that consumers who purchased perfumes used a value system that included primarily: the scent, the brand and the endorsement. Their new value of "having pheromones" would need to replace these other values since they made no effort to meet these other values in the market. I should also add for completeness that they were precluded by the FDA from making clear claims about the attractive nature of the additives to the opposite sex.

3.3.4 Learn from Your Competition

For Pre-existing Categories, when entering a market that is new to you, distribution decisions can simply be made by studying and copying the competition. Of course, I'm not suggesting that you copy their trademarks or patents, but rather their marketing strategies that have evolved over time. For example, if you have a new type of copy machine, simply look to see where copy machines are advertised, where they are sold and who the resellers are, and attempt to move your product in as an alternative to each. Unlike in school, there's nothing wrong with copying. In fact, the less innovation that you do outside of your product innovation, the less is the chance that you're going to make bad choices for the channel management. I've gone so far as to recruit the entire sales and marketing teams intact from competing established companies when building a new company and

I've asked them to simply do exactly what they were doing before, only with a superior product.

3.3.5 What happens when you get it wrong

There are many examples of companies that have misunderstood this issue relating to the definition of new versus pre-existing category. Two good examples are Bowflex and TiVo. In both of these cases the manufacturer attempted to launch the product through conventional retail channels. Unfortunately, each of these products was actually a new category and was not intuitively understood by customers who might have actually enjoyed their ownership.

Later on, in the section on direct marketing, I discuss in greater detail the case of Bowflex, who eventually recognized and remedied the error.

TiVo elected to launch originally through Best Buy and Tweeter, two retail brick and mortar channels that offer electronics and home entertainment equipment. At Tweeter, a smaller, regional chain, there is a more highly trained sales force that was better able to describe the value of the product. At Best Buy, a larger super store, the sales focus is considerably poorer. The result was that the product did move somewhat at Tweeter, with an extraordinarily large investment of sales time on the floor. Unfortunately, it didn't move at Best Buy. The response by the buyer at Best Buy was to lower the sales price, thus making it harder for Tweeter to sustain their higher price and higher selling costs. The reduction in apparent margin left both the manufacturer and the retailers without the ability to invest heavily in advertising which could have been used to build customer awareness of the new category.

For B2B cases, the problem of getting it wrong is related more to misunderstanding the costs of marketing and customer adoption that come with attempting to launch a new category product without adequate time or finances. New categories require both experimentation in the selection of media for lead generation and customer education of the value proposition. All too often, especially when venture funds are raised, expectations can be set which exceed the market's ability to adapt to a new category product.

3.4 Exercise - Category and Value Analysis

Go to a retail store and find a single category with more than one competing product in the category and do the following:

1.

2. Photograph the shelf so as to preserve the presentation of the current products within the category.
3. Create a competitive matrix that compares the various products against one another. Only choose values that are relevant to customers who purchase in that category.
4. Attempt to rate the values in their importance to the customers.
5. Create a prediction as to the market success of each of the products based upon your competitive matrix in combination with your statement of relative importance of each value. Do not forget that values that are "framed" by other products will influence the relative importance of those values.
6. Compare the actual market success of each product to your predicted values.
7. Propose an incremental innovation that could be share shifting within the category.
8. Create a pro-forma anticipated share shifts that will occur once your product is introduced.
9. Design a package for your proposed new product.

Watch a television infomercial and observe and record the following: (If possible record the infomercial and bring it into class)

1. Is this a new category product? If so, why?
    a. What is the problem that is being solved?
2. What is the solution?
3. What is the CTA (or Call to Action?)
4. Is the product available in other channels?
    a. If so, how does the manufacturer prevent channel conflict?

3.5 Customer Identification

Once you've created a product, then the next major question is who is going to buy it? This is a traditional market research problem. Your goal is to identify the: "who, where and how" for your customer base. This is straight forward "gumshoe" investigatory work and requires using the web, the telephone and personal interviews to gather information.

Research typically involves both primary and secondary research.

3.5.1 Secondary Research

One usually begins with secondary and syndicated research on the web or at libraries. The goal is to identify the current market within the category in order to size the opportunity. Often, one can look at:

- Financial reports of public companies in the category
- Web sites of competitors
- Public market research reports
- Competitive advertising

It may be useful to purchase Syndicated research on the particular category and market segment from industry researchers like Gartner Research. These can also be found online.

The goals for this research should include:

- What is the overall category size?
  - By Geographic distribution
- What are the overall trends in the category?
- Who are the major competitors?
  - Relative sizes and profitability?
- What is the total potential customer base?
  - By Geographic or other distribution

Much of this information will help you in the creation of your overall business plan and plans used for fund raising.

3.5.2 Primary Research

I have always strongly encouraged new entrepreneurs to establish contact with potential customers and channel participants as soon as possible, even well before a product exists. It is only through the actual discourse with potential customers that you can accurately gauge what customer response will be. This is especially true for business-to-business cases where actually visiting and presenting your business idea will provide critical feedback.

Primary research can also be purchased from companies like IDC who will conduct either telephone interviews, in person interviews or focus group interviews with attention paid to limiting the survey to people who you consider to be within the demographic of your potential customer group.

When conducting sales interviews, you should attempt to actually sell the hypothetical product or service and gauge the response. Of course, your time will be most likely limited and it is essential that you order your questions in their importance to issues of product design, pricing or marketing strategy.

When conducting primary research, you are interested in gathering the following information (some of this is redundant to the secondary research results):

- Who would buy my product – define the customer demographics?
  - How many of them are there?
  - Where do they reside?
  - How much money do they have?
  - What media channels do they use for information about this category?
  - What channels do they use to buy this type of product?
  - What are their key decision factors when making a purchase?
- Who are my competitors?
  - How much do they sell?
  - At what price?
  - With what comparative features?
  - What channels do they use?
  - What are their financials?
  - How much advertising do they do?
  - Where do they advertise?
  - What is their gross margin?
  - What is their R&D expense?
  - What is their marketing expense?
  - What is their market cap and how is it determined?
- Who are my potential reseller channels?
  - What markup do they expect?
  - What advertising support do they expect?
  - What are the customary payment terms?
  - Are they a stocking distributor or do they only take orders?
  - Does the channel provide service or training?
  - How many of them are there?
  - What is their territorial coverage?

- What kind of experimental programs are available to test market?
    - What motivates the resellers other than profit?
    - Will I need to generate sales leads for my reseller?
    - Will I need to provide my reseller with marketing tools?
- What potential OEM opportunities are there?
    - What major companies have an interest in this market?
    - Do they have synergistic products?

At the completion of this research you should have a distribution plan, a competitive analysis and a good sense of how you're going to distribute your product and how you can possibly generate leads.

When researching a customer base, one often starts with "secondary Research" methods including potentially the purchase of reports done by firms that specialize in industry research. These might include, for example IDC, Gartner, Forrester Research and others. Reports typically include industry trends, business drivers, competition and average sales for several years.

Over the last ten years, the Internet has become an extraordinary tool for performing one's own research using conventional search engines like Google. One can find lists of competitors and carefully examine their offerings. One can also find financial reports on public companies that can be aggregated to better understand market sizes. Public companies listed on US stock exchanges must file what are called 10K and 10Q reports on a quarterly basis. These reports will often detail divisional sales or in some cases product sales levels.

Two of my favorite research tools are to use the Ad-Words, from Google and EBay websites. Opening an Ad-words account is simple and only requires a credit card. There are no charges however when simply conducting research. With a combination of Google search and Ad-words, you can build a trial campaign and literally see who is advertising in the category currently and what numbers of key word searches are done daily for the category in question.

EBay can be used in a similar manner, simply to search with particular key words and to see both the level of activity within a category as well as to obtain competitive pricing information.

Primary research consists of actually interviewing potential customers. Often, this is done over the telephone and can be purchased as a study from companies like IDC. They will both design and implement the study for clients.

I have often seen two small companies get together for the purpose of exploiting one of the company's innovations. I would strongly suggest that you not do this. The channel partners that you will need should be selected to have superior financial or market strength, if possible, so as to compensate for your own weaknesses.

3.5.3 Consumer Database Analysis

With the advent of the credit card and computers, some companies are gathering an enormous amount of consumer based purchasing information. Market research companies include: ACNielsen, Arbitron, Gallup, IRI, JD Power, Mediamark, Nielsen Media Research, NFO, NPD, Polk Automotive, Scarborough, Simmons and others. For each and every consumer, these companies collect consumer behavior. Market research and analysis companies can then stack-rank the entire population for you with respect to your product and can tell you how to price it, how to sell it, and possibly even what color it should be painted. A good example of one such database marketing company is Claritas which offers both consumer and B2B database lists and analysis that can be purchased online. Typical prices for consumer lists are in the range of $40 to $60 per thousand depending upon the number of selectors used to qualify the list with a total minimum order of $600. Alternatively, B2B lists based upon SIC codes start with a minimum order of $250.

For consumer markets, consumers are generally broken down into market segment groups based upon buying habits, income and other preferences. Claritas currently uses the PRIZM segmentation for consumer markets which breaks them down into 45 groups with names like: "Upper Crust" which has, as of the 2000 census, 1,580,481 households accounting for 1.47% of the total number of households in the US. Other group names include: "Urban achievers, New Homesteaders, Domestic Duos…"

If you share your sales data with a company like Claritas, they can provide for you a statistical analysis of that data in comparison to their own segmentation data and tell you, for example, what percentage of your customers lie within specific segments. Then, they can also tell you the correlations between ownership of your product and, for example, other products like an "Exercise Bicycle." Those correlations can assist you with selecting channel placement, or mailing list selection.

For example, you might begin by using a direct mail campaign to sell your product based upon a broad selection of recipients. For this campaign, you would calculate your media costs and run your campaign for several months and gather a few thousand customers. Then, at that point, you can approach a database marketing analysis firm with the zip codes and phone numbers of your current customers and they will assist you with tuning your mailing list to have a higher media ratio by discarding unlikely buyers through segment analysis.

The type of propensity information for your product or service that can be obtained also includes geographic maps with the densities of likely customers on a national or local level, likely TV viewing habits, radio listening habits, magazine and newspaper subscription habits, retail shopping tendencies, travel habits, age, sex, family size, income, education, club affiliation, race, and in some cases specific product or category ownership. A more detailed sample report from Claritas can be found on their website.

3.6 Channel Identification

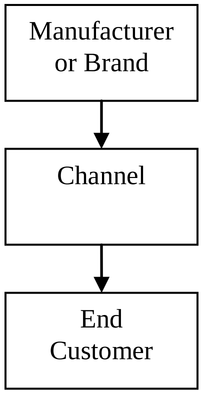


Figure 14 - Channel Flow

Often the simplest method to identifying the channel that you will choose is to ask your end customers where and from whom they would most likely buy your product or service. For example, if you have products aimed at plastic surgeons then begin by contacting plastic surgeons, showing them your product (or product concept) to gain an appreciation of their view of your value proposition and ask them how they would expect to buy this product. Thus, they can give you important information about channel selection. By "Channel" I am implying any business entity that buys and resells your product, even on consignment.

Most entrepreneurs are seduced into the possibility that they can either live without the established channels or that one channel appears more profitable than another. My experience is that neither is true. The Darwinian nature of business has resulted in each channel option being trimmed down to minimum profits and that they are all roughly equivalent. Therefore, if it is true that direct TV marketing for a product requires approximately a 5 to 1 ratio between the selling price and product cost, and if half of the total revenue goes into the media advertising cost, then it's probably also true that similar ratios are needed through alternative brick and mortar channels with the difference being where exactly the money is spent.

There are a significant number of alternative channel selections for any product that may include, for example: Direct Marketing (through TV, radio, print, mail, etc..), brick and mortar retail, stocking distributors, resellers, etc. The selection of the proper channel for your product depends heavily upon its category.

If your product is in a pre-existing category, then it should be possible to quickly ascertain how competitive products are already distributed. Attending trade shows as a visitor, searching through trade journals for advertising, going out shopping and doing web searches can all be used to provide this type of information. When approaching resellers who are already carrying competitive products, with the exception of retail share-shifting, it is often unwise to allow your product to be sold by a representative that is carrying a competitive offering.

The creation of a competitive analysis chart, as shown in the discussion of pre-existing categories, will assist you in convincing resellers to handle your product. As well, you will need to understand the typical margins being offered by your competition to the channel and how you can make your product more attractive to them by providing them the opportunity for more profit.

Keep in mind that your channel partner is a business and as such, the value system on which they decide which products to resell is based upon value to them, and not value to their customer. Values to a channel partner are discussed in greater detail in the chapter on value.

As you gain an appreciation for who participates in your channel it is important that you start to quantify their businesses and attempt to build an understanding of how the introduction of your product may change the playing field for them. Often, the introduction of a “sea change” product can disrupt market positions and provide you with considerably more leverage than first thought through simply analyzing the profit that can be made from resale of your product.

3.7 OEM Relationships

An OEM relationship is one where a product is designed and manufactured by one company but sold through another which may choose to use its own brand or a combined brand. If your company is based upon the development of a new product, then building an OEM relationship or partnership with a stronger company that manages the distribution can be an excellent way to avoid needing to raise capital for marketing and selling expenses.

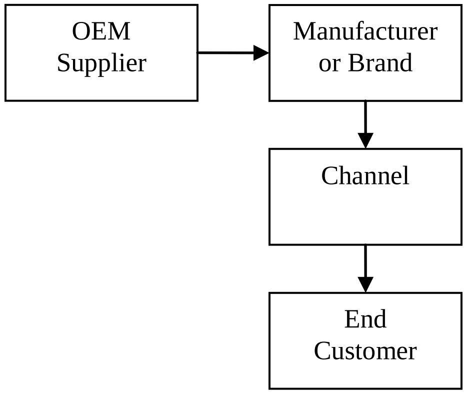


Figure 15 - OEM Structure

The key differentiator between an OEM partner and a channel partner is the assumption of risk in exchange for some recognition, control of distribution and profit by the OEM partner.

In some cases, a channel partner for one product can be an OEM partner for another. For example, Kellogg's sells Kellogg's cornflakes through retail food stores in a typical channel relationship deal. But as well, they also manufacture the store branded cornflakes that are sold at a lower price without any mention of Kellogg's brand.

To demonstrate the different risk: Unsold and expired Kellogg's cornflakes might be returned to Kellogg's for a refund (Depending upon the specific nature of the deal) while unsold store branded product is disposed of and lost revenue to the retailer only.

To demonstrate the different revenue, the Kellogg's cornflakes sell at a higher retail price and are transferred to the retailer at a higher price than the store branded OEM product which provides potentially more profit to the retailer (depending upon the spread between cost and list price.)

To find a potential OEM partner, the search begins with your intended customer. Which companies have brand equity with these customers? Which companies have a distribution channel that reaches these customers? Assess companies that are already in your category being careful to understand whether conversations will tip your hand concerning your innovation with the category. Then, assess their financial strength, distribution strength, manufacturing strength, brand strength and most importantly try to project what the impact of having your product would be to their business. This is not as simple as it might appear. For example, the first and most obvious impact would be the additional revenue and profit associated with the sale of your product. However, other critical impacts could be:

- The increase in their profit through the amortization of selling costs of their current products over a larger product family
- The enhancement of the position of their current brand or product line through the appeal of your product. This is especially powerful if all of the current market participants are competing for market share with basically indistinguishable products and your product provides differentiation within the category. Since the inclusion of your product might influence the share-shifting within a much larger market, the value of your innovation can be significantly more than what you might expect its sale value is when considered in isolation.
- To provide prestige, press coverage or public relations advantages which enhance the sale of other products or stock value

For you, the value of an OEM relationship is to reduce risk, the need for cash, and they can provide you with essential information and guidance for the continued development of your product if they have been active in the category for some time or have significant access to customers who would be using your product.

Typical OEM terms deal with the following issues:

- Territories or vertical market segments for which some sort of exclusivity is offered.
- Time restrictions for exclusive rights.
- The transfer price.
- Minimum performance to retain rights.
- Ordering schedule and notification requirements for changes.
- Non-compete and non-recruitment of employees
- Payment terms including deposits, delays and methods.
- Escrow of technical information
- Termination rights, reasons and cure periods.

Begin the negotiating process by creating a joint Letter of Understanding (LOU) which simply outlines in plain English what the terms of the deal will be. Later on, a legal group can carefully construct the precise wording of the agreement. It's generally advisable to get your OEM partner to agree to allow you to initiate the authorship of the contract as opposed to letting them start. Use an attorney of your own when you are ready for the entire agreement. Just keep in mind that attorneys are good at legal advice but not business advice. You must decide what terms represent acceptable risk for you to achieve the business goals that you desire. Other conditions that may be included in the contract are:

- Product customization
- Product delivery
- Product acceptance
- Royalties and payments
- Quantity and pricing
- Training
- Terms of the contract
- Renewal and termination
- Marketing and press releases
- Proprietary information
- Disclaimer of warranty
- Infringement
- Title and right
- Assignment
- Arbitration
- Notices
- Governing law

Often, startups can use a combination of OEM relationships and their own distribution strategies to afford additional stability and reduce risks and the need for capital while still providing a long term strategy that builds brand awareness for the startup. Many companies will, for example, develop direct distribution in the US and pursue OEM partners for overseas distribution.

The key to maintaining a long term and profitable OEM relationship is to make sure that you continue to enhance and develop your product. If you remain stagnant, then you will entice your OEM partner to eventually replace you either with a competitor or often with their own design.

From the perspective of the larger company, their motivation starts with their desire to keep research and development costs from affecting their reported profit. An OEM relationship is perfect for them since all costs show up as product costs which are offset by sales with included profit. They also will have avoided the risk of developments for products that fail. From your perspective, the one thing that they should definitely have is a stronger balance sheet than you and as such they should be forced to provide you with deposits and immediate payment. Extending 30 or 60 day payment terms to a large OEM should definitely NOT be done. The reason that they love you is because of your product not because of your ability to finance their payables. You should expect, however, that they will demand and expect low prices so that they can make adequate margins. As well, you should expect that the negotiating process will take some time in that large companies attempting to make large commitments require a large number of people to agree.

Once you identify a potential OEM target, you must then find a champion within their company who can spearhead your sales effort within their political structure. Most often this will be someone from the sales or marketing departments. Doing this requires that you cold-call the sales department and start to seek out a champion. Fortunately, the sales organization of your potential partner is the most open part of the company because it is actively seeking relationships with new customers and because it is driven by revenue goals and is more often open to new opportunities.

The depth and experience of a larger OEM can help you to even out your sales, validate your market and promote your technology and corporate identity to the customer base.

For example, many digital cameras are designed and manufactured in Asia by companies like Pretec that are independent from the branded resellers here in the US. Vivitar is a branded re-marketer of Pretec's cameras. They sell cameras under the Vivitar brand. To do so, they import and sell the cameras to retailers like Wal-Mart. With the advent of the Internet, many brand marketing companies will sell directly to retail customers as well through the Web.

Therefore, one would consider Vivitar to be an OEM customer of Pretec. In this case, Vivitar doesn't even have engineering or development capability. The product is completely designed and built by a third party. Often, branded resellers will travel to Asia to see what next year's models will look like.

Of course, every business relationship between two companies can have its own terms and conditions. However, in general, OEM manufacturers avoid all inventory risk associated with the product. They have incurred the development risk but they will not actually build any volume of product unless the payment terms are irrevocable. Typically, the brand re-marketer will be asked to issue an LC or Letter of Credit which guarantees payment. From the perspective of the buyer, posting an LC is committing cash. The buyer must either transfer the cash or use a credit line to secure the payment to a bank that acts as a clearer of the funds.

From the perspective of the manufacturer, the funds are received typically upon the presentation of proof of shipment from the manufacturer's facility. Thus, payment is made before the goods are received and inspected. Often, a new buyer will inspect the quality of the shipment prior to shipment while still on the dock of the manufacturer.

One reason that the payment terms are so concretely defined is that the product and its associated literature and packaging are typically marked with the brand of the buyer. Therefore, the goods could not be otherwise disposed of by the manufacturer if the buyer decided to back out of the deal after the goods were built but before they were delivered and paid for.

An OEM relationship spreads the risk between the parties. In the case that I have described, the manufacturer absorbs the risk of development but avoids the risk of inventory, and returns if the product does not sell through to the consumer.

In some cases, a manufacturer can be approached by a branded reseller with a design owned and created by the branded reseller. In these cases, the manufacturer is typically referred to as a Contract Manufacturer. The manufacturer attempts to offer the best manufacturing cost but will not assume any risk of non-payment through the LC payment method.

Of course, large reputable branded resellers have the leverage to force payment terms that might not include an LC. In a free market environment, a more financially solvent manufacturer might be willing to accept the risk of late or non payment for the benefit of a large order with a major brand. This would be called having an Open Line of Credit for payment with a manufacturer.

For a small entrepreneurial company the use of an OEM relationship can mitigate risk and spread the costs of developing a business out over a number of parties. For example, let us assume that you have designed a new and innovative digital camera. You believe that the innovation has tremendous value and will give the brand that sells it considerable market leverage.

Unfortunately, the costs of setting up manufacturing, marketing and a sales organization will force you to sell stock to raise capital. Alternatively, you could approach a company, like Vivitar, with a strong recognized brand, and with all of the capability and cash to distribute your product internationally. You could attempt to create an OEM relationship with two parties, Vivitar, a branded reseller, and a manufacturer of your choice who will build the product for you, to be in turn, shipped to Vivitar.

Assuming that Vivitar likes the idea, your credit terms with Vivitar can also be with an LC as described above. In fact, the LC that Vivitar posts to you can be used to secure, through a bank, the LC that you post to the manufacturer that builds the product.

In this case, you assumed the risk of the design, and the manufacturer that you selected assumed more of a Contract Manufacturing role. Your relationship with Vivitar is that of an OEM supplier.

This arrangement of using a small company to do the research and development for the creation of a new company is actually of great benefit to the large OEM reseller. Typically, the larger company has a more formal financial structure and may have public stock ownership. Companies like this are driven for quarterly profit performance. Unfortunately for them, research and development costs cannot be generally amortized over the life of the product, but rather, must be incurred when spent. Thus, in the drive for pennies of profit per share, large companies are reluctant to incur R&D expenses.

The marriage with a small OEM provider that incurs the R&D costs and provides a completed product to the OEM reseller spreads the cost of R&D out over the life of the product by charging a profit paid to the OEM manufacturer (the design company) on each unit sold.

At first blush, this would appear to have the obvious disadvantage that the small OEM provider must incur the cost of R&D while they in fact are poor and unable to find these funds. But, there are even ways around this problem. One can approach a large OEM reseller and get from them a commitment to purchase a newly developed product before it is designed. Of course, this relies upon being able to establish credibility with the OEM reseller. As well, the purchase order would probably be contingent upon the successful development of the product.

The purchase order represents value for the company that can assist in the raising of funds. But, better, it is sometimes possible to obtain a deposit with the purchase order that can actually be used to finance the development without any stock dilution. The reason that this is possible is that, again, from the perspective of the large OEM reseller, the deposit is merely a balance sheet transaction (the moving of cash to a loan account) and has no effect on their sacred Profit & Loss for the quarter. As the deposit is credited to shipped product, the loan is repaid and the net effect is identical to not having a deposit at all.

Of course, the risk to the large OEM reseller of losing the deposit in the event that the smaller company fails to perform is real and requires a benefit to the former company that is tangible and worth the potential future pain of having to write off the deposit if the development fails.

In many cases, small growing companies desire the opportunity to build their own brand, sales and marketing. Often, OEM relationships with more established brands can be mixed with the development of your own brand. In the simplest case, this can be done by choosing OEM partners that have distribution channels that can be clearly separated from your own intended channels. For example, you can build an OEM relationship with a European brand that tends to sell only in Europe while you concentrate on the US. Alternatively, often there are parallel channels within a specific geography for similar but somewhat specialized versions of the same product.

For example, the manufacturer of a night vision infra-red viewer can seek OEM relationships to sell a version of the product to the fire protection market while a version for hunters is manufactured and sold under the brand of the manufacturer.

For our three case study examples, it is useful to examine whether OEM sales relationships could have been effective for them.

For TiVo, who had the principal problem of needing to create a new category, I suspect that establishing an OEM relationship through; for example, cable companies early in the product cycle would not have benefited TiVo. This is because the cable companies had effectively a monopoly on their service and would have needed to still explain the value of TiVo to their customer base, something that they might have been unwilling or unable to do.

Likewise, the Pixifun product also needed to establish a new category and in the same way, shifting the burden to another company could have reduced the direct cash impact on the manufacturer but without a direct campaign the product would still fail.

Alternatively, Erox had an excellent opportunity to exploit an OEM relationship with one of the major perfume brands. They were all competing with relatively identical products and any of them could have clearly enjoyed having an innovative advantage that they could have exploited through their own deep advertising budget.

My advice for negotiating an OEM agreement is: be patient, be fair, namely try to consider finding terms that are good for both parties, and be creative. Don’t start with any assumption about what is or is not possible.

3.7.1 Exercise - OEM Contract Creation and Negotiation

Based upon your birth date:

If your birth date is odd, Read the Large Company description in the attachments section. Do NOT read the Small Company description.

If your birth date is even, Read the Small Company description in the attachments section. Do NOT read the Large Company description.

1. Create a proposed term sheet for negotiation with an opposing team member. Think about the creation of a win-win contract that leads to combined success.
2. Identify one student who is from the opposing group and pair up and negotiate a term sheet that is agreed to between the parties.

3.8 Selling

Being an effective sales person is a skill that requires training and talent. Selling requires being an advocate of your customer and of your company. It requires discipline and hard work. All too often, entrepreneurs believe that anyone can sell. They cannot. I have even heard it recommended that "everyone in the company should rotate through the sales organization so that they can understand what the customer needs." While this is an admirable goal, to me it would be like rotating everyone in a hospital through the brain surgery department.

3.8.1 Search and Destroy

There are two different modes of selling or engaging with customers which I will refer to as "Search" and "Destroy." They are quite different, yet are both essential for small businesses. Search Selling involves the attempt to identify business opportunities that lie outside of your current product or service repertoire. Destroy Selling is focused on moving a customer through a predefined sales process or adapting the sales process to the customer, but still focusing on getting the customer to commitment for a current product or service.

The Search Selling technique is most useful when dealing with B2B opportunities since the value propositions are mostly based upon rational value structures. Of course, you can use Search Selling with consumers, but larger sample sizes are needed and one must be careful to understand the real value of the offered solutions.

Search Selling is especially important when a company is small and when its current products or services may have only marginally compelling value propositions. When a company successfully grows, the process of Search Selling falls into the domain of a vice president of business development while the Destroy Selling falls into the domain of the vice president of sales demonstrating the importance of the continuation of both.

It's extraordinarily difficult to find the balance between these two types of business development processes. As a company grows the need to focus the sales organization on selling the current products and refraining from "inventing" in the field is essential for achieving stability. Yet, for the first several years of a small company's existence it is likely that it will need to step between various business models that represent ever expanding opportunities. The method of Search Selling is used to identify and approach these new opportunities.

3.8.1.1 Search Selling

Search Selling is mostly about learning the customer's own business model and listening carefully for pain points that can lead to business opportunities. Think of this as sort of an "interview" process where your goal is to quickly interrogate the customer and understand how their business works. It might start with, for example, a plant tour where the customer shows you their various operations. It's critical to use this opportunity and time to learn as much as possible about the business that you're visiting.

For example, you might ask:

- What are your sales?
- Who are your customers?
- What channel do you sell through?
- How many customers do you have?

Obviously, this needs to be done in such a way as to not appear too pushy, but rather to appear sincerely interested in the customer's business. All the while, you must be carefully listening for problems and pain points that can represent opportunities. Later on, after digesting the information, you can return with a trial proposal for a product or service that can eliminate a pain point and solve a problem.

This is the essential opportunity process that small businesses use. It demonstrates two important issues:

- Your current product or service might have a weak value proposition and yet it can still serve as a "door opener" allowing you to start a Search Selling process with a potential customer.
- The random walk that small companies go through is often directly affected by the opportunities that are discovered during this type of Search Selling.

3.8.1.2 Learning a Business Model

Probably the most important data that you can collect when in the Search Selling mode is to gather an understanding of your (potential) customer's business model; to understand how their business actually works on the inside. As well, it is helpful to understand how individuals are compensated, especially if their compensation is variable as often true in the case of sales people.

I will illustrate with two examples.

Retail business models are interesting to understand. If you walk into a sophisticated retailer you will observe that there aren't any empty shelves. A retailer's business model can be simplified to an understanding that they just rent shelf space to their suppliers. The metric that they can use to manage their selection of products is "return per linear inch of shelf space per day." Understanding this, can lead to a better understanding of how a retailer makes decisions on new products. A retailer doesn't need any new products to fill holes in their store. They don't need or want a new supplier that adds complexity to their process.

As well, the category manager who is in charge of the selection of products (and vendors) for a specific set of shelves is compensated partially on the coop advertising that he "sells" to his vendors. Thus, vendors have a direct influence on his decisions.

As a second example, for many years, my second company sold products to newspapers and wire services. Newspapers are interesting businesses in that they are a combination of four somewhat unrelated and disconnected business models that share a common platform:

- Editorial and News
- Subscription
- Classifieds
- Advertising

Clearly, of late, the newspaper industry has been experiencing serious stress (or pain). The classified sections of the newspaper have been decimated by Craig's List, which for many years wasn't even a business in that it had no viable revenue model.

The advertising component as well has been under relentless attack from the Internet leaving the subscription and editorial sections untouched but underfunded.

Observing these types of divisions and changes offer the ability to create products and services that can help to remove pain and find solutions. For example, the subscription delivery service network that is used by newspapers has potential values for other businesses and as of yet has not been exploited.

3.8.2 Destroy Selling

The process of "Destroy Selling" is the more traditional view of selling and is covered in the remaining part of this chapter.

3.8.3 Sales Preparation

Don't be too eager to make in-person (called belly to belly) sales calls without first qualifying potential customers carefully on the telephone. Direct selling is far too expensive to be wasting time on unqualified potential clients. *I say this with the important exception that when you are first developing your business plan it is essential that you engage with customers in person so as to insure that you correctly understand your value proposition and opportunity.*

Qualifying a potential customer involves creating a list of criteria that you believe through empirical evidence is necessary in order for a potential to become a real customer. For example, a certain level of income or asset strength might be a necessary prerequisite to buying a certain value home. Of course, exceptions will always exist. Most often, the qualifications deal with authority, need, experience, current status, etc.

In addition, preparation before a person-to-person sales call is essential. I like to use PowerPoint presentations when selling since they give me the excuse, especially in a small group, to stand and assert control over the flow of the meeting. Without the PowerPoint slides it would be a bit awkward to stand while others remain seated. Slides should be simple uncluttered points that you elaborate on during your sales pitch. You don't want to either be reading the text or having the audience be reading along while you are speaking. Sometimes simple images along with bulleted items are more than enough.

3.8.4 A Typical Sales Presentation

First, you're going to tell them what you're going to tell them. Then you're going to tell them, and finally, you're going to tell them what you told them. Redundancy and clarity are central to a presentation.

A typical sales presentation should be able to be done with 10 PowerPoint slides:

- A summary of what I'm going to tell you
- Who are we
- The problem that we are solving
- The product or service that I have (2 or 3 slides)
- The value to you
- The transaction that I would like
- The reason to act now
- A summary of what I just told you

It is interesting to note that this initial presentation will in all likelihood not vary whether you are selling financial services or wrenches.

3.8.5 The Sales Call

The first challenge is simply to be liked. People do business with people that they like. As a result, most good sales people learn to quickly absorb the preferences, likes and dislikes of potential customers through picking up queues from their office like pictures of vacation spots, family, and pets. I've frequently heard good sales people develop southern accents when selling to southerners.

As a rule of good selling, never discuss politics or religion. People carry a lot of emotional baggage with these topics and as a sales person you want the customer to identify with you and see you as an advocate. There is no need to either determine or declare your political party affiliation, sexual preference or religious affiliation. Keep it neutral.

The sales person serves a roll of advocacy for both the customer and the company and must constantly appear to be taking on the roll of assisting the party with which they are currently engaged.

I've known many sales people who considered their customers to be their own property. As they changed jobs, often to a competitive product, they took their customers with them. That would seem incongruous to many. After all, they were selling against that very product only last week. Yet, they establish an advocacy that is trusted by their customer and they are able to lead their customer even to what might be considered irrational conclusions from an external vantage point.

The second major challenge for the salesperson is that of communication. You need to be able to quickly and effectively communicate your product value to your customer. Good communication requires the ability to listen. You need to understand whether your customer understands you. As well, you need to determine if your customer perceives their own need as being real for your product.

Your third challenge is that of mind-share. Your goal is to get your customer to spend more time thinking and acting about your product. This is especially true when your customer is a reseller or distributor of your product.

Your fourth challenge is to quickly understand objections and to move the sales process forward through those objections as efficiently as possible.

Figure 16 - Sales Pyramid (or ladder)

Next, you must identify who, within your customer's organization serves as either a decision-maker or a gate-keeper (someone who blocks access to decision makers). The price of your product and the total value of the engagement will determine who, within the customer's organization, has the authority to make the purchase.

Your final challenge is to understand and analyze when sales are lost and to help your organization to understand how to change either the product or the process so that sales efficiency is raised.

A process for tracking and organizing the selling process involves the use of a sales pyramid which is also known as a sales funnel depending upon whether the wider portion is on the top or bottom. Products like salesforce.com or other CRM (Customer Relationship Management) software tools often provide sales pyramid information as part of the report generation. The pyramid is divided horizontally into segments that describe the process steps for making a sale as might be defined in the sales ladder. At the top of the pyramid is a closed order and at the bottom are newly generated leads. The reason that it looks like a pyramid is that there should be more leads than orders and potential customers should be falling away from the process over time, shrinking the funnel at its top. Actions are taken by the sales department to move a customer up through the pyramid.

Over time, the actions become formulaic and are learned from early sales. There is no set rule as to the number of stages in the sales pyramid. However, the organization's goal is to codify the process as much as possible so that all leads are handled in a similar fashion by all sales people and then to track the selling system through a weekly Pyramid Report. With a pyramid report it becomes possible to see where there are logjams within the process and address those areas quickly before they affect financial performance. For example, advertising is not generating enough new leads, or the demo process isn't moving customers to commitment. Then, the organization can effect improvements in the process. It also becomes statistically possible to forecast revenues with greater accuracy by looking at the number of potential accounts that are in the pyramid at any one time. Pyramid reports can be expressed in either the number of customers or dollar value of potential orders.

Sales Pyramid Report

	Week 1	Week 2	Week 3	Week 4
Sales	21	22	21	20
Level 2	41	35	30	26
Level 1	60	71	65	67
Leads	150	142	157	145

Figure 17 - Sales Pyramid Report

For example, in the above simplified Pyramid Report, one would notice that there is a problem moving potential customers from Level 1 to Level 2 in that the level 2 quantities are trending down even though sales leads seem stable. The effect on Sales has not yet been noticed because of the pipeline delay of the process. Early intervention can help before the dip in sales is seen.

Once the concept of the sales pyramid becomes understood, it becomes more natural for the sales people to understand transaction oriented meetings and discussions. All interactions with customers should be orchestrated to be transaction oriented. By that I mean that the sales person must have a specific goal (or alternative set of goals) in mind before the meeting with the intent of moving the meeting to one of the desired goals.

For example, in the above pyramid, meeting with a customer who has already received a brochure, would be directed at setting up a demonstration of the product. Obviously, if the customer was already well convinced to move to ordering, then by all means, the sales person would accept this transaction instead. The key is to not let a meeting dissolve without a transaction that has been targeted.

Often, transactions and pyramid levels deal with addressing different people within an organization. There are, for example, gate keepers and decision makers who must be addressed when launching a sales campaign against a specific customer. The goal and responsibility of the sales person is to map out the organization of the buyer and to understand where and how decisions are made and financial commitments are made.

Most often, the specific dollar amount that is being asked for will dictate at what level the commitment can be made within the organization.

I have frequently been called in to assist a company with a sales and/or marketing problem that can simply be stated: “sales are below expectation.” A sales VP that I once worked with had the following test that he would apply in similar situations. If there is a sales force from which one can find a single successful sales person, then it’s a sales training problem. If, on the other hand, none of the sales people are successful, then it’s a product problem. The same test and logic can be applied to different channel partners or retail stores.

3.8.6 Public Speaking Tips

Often selling to a group is similar to public speaking and requires many of the same skills. Here are some tips to effective public speaking:

- Pick a few (two or three) attendees who are paying attention and shift your gaze between them while talking. But, talk directly to the one that you are looking at. This will both give you more comfort and by establishing eye contact will give you more credibility. It will also give you some feedback as to when you’re not being understood or are not moving quickly enough.
- Do not begin your presentation with open-ended questions of the form: “How many of you enjoy eating fast food?” There are two reasons: First, you don’t want to lose control of your meeting with random or worse, potentially negative responses. Second, it’s often true that establishing the self-reference criteria of the audience is not relevant to the sale. For example, it’s possible that everyone that works at Wendy’s doesn’t like fast food and wouldn’t eat it, but they love selling it. Don’t confuse the behavior and preferences of potential channel partners or investors with those of customers.

- Much like learning a song, you should rehearse your presentation enough to be able to speak entire paragraphs without reading them and with only bulleted points on a presentation serving as cues.
- Give your audience time to digest important points. Small pauses after key statements are essential.

3.8.7 Transaction Selling

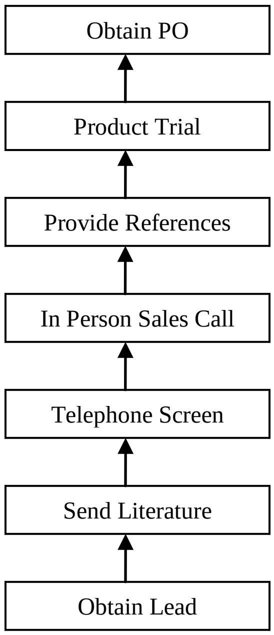


Figure 18 - Sales Ladder

I've attended too many sales presentations where the sales person had no idea what the transaction was that they were shooting for. The meeting finally ran out of steam, everybody shook hands and nothing was done. At trade shows we call this "happy talk."

The goal for a sales meeting is to move the customer closer and closer to a commitment to purchase. If it's not possible to extract a purchase order at the sales meeting, then at minimum, one should feel that they have successfully moved the client closer to that eventual commitment. Or, alternatively, one should move to a resolution where you can clearly understand that a commitment cannot be made and why.

Once you have experience selling a particular product, you will come to understand that there are gates through which you must pass in order to close a sale. For example, a particular product might typically require a trial period, or approval from a finance department. It is essential that eventually, you codify the selling roadmap and then use the transaction process to move the selling process from gate to gate. This roadmap of gates is typically called a sales ladder. The goal of the sales person is to move the customer up the ladder.

Before you start a sales call, have three transactions in mind: good, better, best. The selection of which one to use is based upon the response level during the meeting. For example, if a customer is only mildly warm, then the transaction might be to set up follow-up meetings with other decision makers or influencers in the customer's organization so that a consensus can be built.

Alternatively, if the customer is warmer, then a trial period might be called for where the customer agrees to take the product, try it and keep if it meets his needs.

Finally, if the customer is well convinced, then ask for the order.

Do not end a sales meeting without attempting to close a transaction. I have never regretted pushing too hard. It is relatively simple to back off, but it is inexcusable if you leave without asking.

Lots of salespeople talk about a “trial close” or liking it when they get a “no.” The trial close is my favorite method of selling. It goes like this:

After some discourse during a sales call, one gets the impression that the customer is close to committing but there are certain reservations. The sales person identifies the reservations one by one and then states:

“So, Mr. Customer, if I were to eliminate this reservation, may I assume then that you would give me the purchase order now?” At best, I would even write a purchase order for them to sign with the proviso in it that eliminated the customer’s responsibility to pay if the caveat was not met.

My tendency is to push the process to completion even if I believe that I may not be able to meet the customer’s reservations. In that way I am certain that I have a clear sense of the point at which they are willing to commit. I can always come back later and say: “sorry, but I found that I really can’t do that, so I guess it’s not really an order. I’ll be back if things change.”

Make sure that you don’t stay too long; you’ll only get into trouble. It’s important to recognize when you have achieved your transaction objectives and leave. I’ve seen sales people stay too long and have new objections and concerns be raised after a decision was made, only to spoil the deal.

Another important concept in selling is to understand the specific motivations of the person that you are presenting to. Selling is always personal, it’s to a person, not a company. You must try to determine why this decision to purchase your product is important for them to achieve their personal goals. I truly believe that most people make decisions with more attention to the personal impact than to the corporate impact. With this in mind, note that most decisions within a corporate structure are made so as to reduce the risk as opposed to enhance the opportunity.

Employees understand that a bad decision can cost them their job, while a good decision might yield additional profit for the company but no additional earnings or promotion to the individual making the decision.

3.8.8 Anticipating Your Customer’s Issues

When negotiating with a large company there are often issues that will be raised that make sense from the larger company’s perspective. For example, my favorite is the “hit by a truck” problem. Larger companies will typically have difficulty with the risk posed by doing business with a small company and thus state: "what happens if you get hit by a truck?"

The best way to deal with these issues is to be the first to raise them and to have solutions when they are raised. For example I would suggest early in the process: "I'm sure that you're concerned about doing business with a small concern, so as part of this agreement, we will escrow all of the confidential and proprietary design documents with our attorney, to be handed over to you in the event that we are no longer able to perform."

The key is not to wait until your customer raises these issues. The sooner you get to a closed deal the better it is for you.

3.8.9 When Something Works

Often, when consulting for a small company that is unhappy with their current sales level, I've started by simply asking: "what has worked so far?" Then, my advice is usually to attempt to simply replicate that model over and over again. The key factor that helps my client is that what is eliminated is a lot of shotgun marketing and thrashing around.

For reasons that I don't understand, often small companies shotgun their marketing programs and spread around marketing investments to many different and often unrelated campaigns. I believe that some feel that there is serendipitous benefit that will come from this.

On one hand, what they are doing does make sense: the investment of small amounts of money into a wide variety of media and campaign types, for example: trade shows, print advertising, email direct mail, public relations will offer the metrics (if tracked) that can guide further investment. However, what I tend to find is that they never make the effort to track the performance of any one campaign nor do they compare campaign performance on a metric basis and then make further marketing investments accordingly.

3.8.10 Corporate Size Doesn't Matter

I once had a VP of sales for whom the company never had enough people. When we had six, he would tell the customer that we were 10, when we finally were 10, he told them that we were 20. Clearly, his insecurity was internal and not based upon some absolute requirement.

I have found that honesty is the best policy. Your innovation and the value proposition that it has must carry the order and not your appearance of corporate size. In fact, pretending that you are larger than you really are can have the negative drawback that it implies that you don't need the payment or deposit concessions that in fact you do.

I've never had a customer tell me "no" based upon the size of my company. And frequently, I've literally said: "I have the product that you need and you have more money than God, so you help me by getting me money and I'll help you by making sure that you have the best possible product."

3.8.11 Sales Team Compensation Plans

In general, for your entire company, you will need to create compensation plans that provide motivation and reward for exemplary performance. This is even more the case for your sales organization. Typically, employees in the sales role, up to and including the vice president of sales are heavily compensated for sales success. Typically, one might find two thirds of their compensation package as base pay and one third contingent upon their hitting their sales objectives. The variable portion is also allowed to grow, often to as much as more than their base pay for exceptional performance. Thus, it is not unusual in a successful company to see the VP of sales making more than the CEO.

Variable portions of compensation can be a function of revenue, landing new customers, profitability etc. basically based upon whatever the objectives are for the organization. However, keep in mind that sales people are, in general, very good at optimizing their behavior for the benefit of their own income. If the compensation plan has the potential of being abused in such a way that it increases the benefit for the sales person at the expense of the company, don't be surprised if it happens.

For example, sales people who are compensated purely on sales will often land sales that are difficult to collect. Or if they are compensated on closing new accounts, then a remarkable number of new accounts that have marginal value to the company might appear.

Clearly, what's good for the company should be good for the employee. For example, it is important to make sure that contingent pay is conditional upon receipt of payment from customers and net of any returns. This also forces your sales group to assist with collections and resolution of customer complaints.

The biggest danger for a small company is to lose focus on the development of its own business plan and to start to chase tangential orders discovered by your sales organization. While sometimes it turns out to be true that an important opportunity can be discovered by sales, for the most part, it is more important to make sure that they remain focused upon execution of the existing sales plan. If the plan isn't working, then change the plan.

This is why the position of VP of Business Development is separated from the VP of Sales. The intent is to keep the sales organization focused on "Destroy" selling while the VP of Business Development can engage in "Search" selling in the quest for new business opportunities that lie outside of the conventional product line.

As CEO, your responsibility is to be monitoring your sales organization's pyramid report and to make sure that there are not roadblocks that need to be addressed. As well, you should be forcing the organization to eliminate poor performers and reward good performers. You should also be spending time with customers even after you've had the good fortune to develop a sales organization. It's basically good business for the CEO to constantly be "out there" with the customer supporting the sales process. That said, however, the CEO should make it a habit to NOT visit customer accounts without the sales person who owns the account. Otherwise, one risks moving ownership of the account performance to the CEO and away from the salesperson.

3.8.12 Starting with a Willing Buyer

The process of lead generation is most often to pre-select potential customers who have already made the decision to buy a category participant. It is far easier to sell a product to someone who has already decided to buy and is making a selection within a category.

Most entrepreneurs forget this simple concept when it is time to sell their company. It is far easier to sell your company to another company that has already made the decision (most likely at the board of directors level) to do some sort of acquisition. Typically, acquisitions are done because, the buying company may have too much cash, or too highly valued stock or may need to build revenue or profit.

Even if you can find a better fit for you company with another firm that has not yet made the emotional decision to make a purchase, you will be better served going to someone who is out looking and for whom your fit is less compelling.

3.8.13 Channel Sell-Through

A common error in selling and one that can cause a tremendous amount of harm to a startup company is to not understand or track actual sell-through for your product. Often, it's much easier to sell a channel partner like a distributor, or a retailer, on the merits of your product than it is to actually see the product successfully move to the end customer. In many cases, the channel partner actually perceives the deal with you to be a consignment of goods that will not be paid for until the product sells-through. This is true even if you have, what appears to be a valid purchase order. The channel partner will simply suggest, if not able to sell the product, that you either lower the price, or take it back.

Thus, inventory that you believe has been sold and converted into a receivable is not really sold and is still your inventory. I've seen many companies choke on the returned inventory that a reseller was unable to sell-through.

This implies that many companies have really two different marketing campaigns that must be managed:

- A channel partner campaign with a value proposition aimed at the channel partner
- A consumer campaign with a value proposition aimed at the consumer and directions to fulfill their desire through your reseller network

As an example, we return to the prior mentioned fat reduction system that operates through the administration of laser and massage by a professional. The marketing campaign of this company must:

Establish a lead generation system and sales technique for selling service providers like Plastic Surgeons, Spa operators, dermatologists, etc.

Create a method to draw consumers into these facilities to buy the service of having this procedure done.

In the latter case, the best methods might be to leverage the marketing capabilities of the resellers as opposed to taking on the cost of a broad direct campaign aimed at consumers. For example, providing pre-printed direct mail pieces to the resellers and allowing them to provide mailing lists and costs can be more focused and more cost effective than a broad television campaign.

3.8.14 Selling Cost

Once you've actually sold some product it's essential that you eventually be able to describe numerically exactly what the average selling cost was for your product. For example, how many letters needed to be mailed, advertisements run, sales hours spent, etc. before an order is closed? It is only through this analysis that you will be able to build a profitable business. You will need to understand it so that you can fix it. The total selling cost should be the sum of all of the marketing costs and the direct selling costs divided by the number of units sold.

3.9 MARCOM

3.9.1 Creative

A fun part of the process of creating any advertising is the creative process of building the advertising message, regardless of the media that is used. Over the last 10 years, there has been an explosion of the quality of available tools and source materials available over the web. It has truly become possible for even the smallest company to present an image and message that is as sophisticated as those found from the largest.

Images can be an important part of your story. Historically, custom photography was an expensive part of the creative process. Today, with tools like digital cameras and software like PhotoShop, even amateurs can build impressive ads. Stock photography sources like http://www.corbis.com can provide you with a selection from thousands of high quality images. Typically, the fees reflect the volume of distribution and the level of exclusivity that you require. In general, there are inexpensive sources of high quality images that are easily accessible over the web.

Page layout also used to be quite expensive, but today with tools like Microsoft Word, impressive print layouts that are publication ready can easily be built.

What is most important to consider is that most advertising is qualified on a trial basis. Thus, the ability to easily and rapidly change the creative components for additional tests gives you tremendous power to tune a campaign effectively.

When beginning an ad or web development, start by collecting the following components for assembly:

- Key messages that communicate the value proposition clearly. For new category products this would include a fairly compact but complete description of the product.
- Images that convey the value proposition. You can sample stock photo images that carry a watermark for no charge. You will be charged when you choose to buy the version without the watermark for distribution.
- A call to action that will motivate the customer to act.

- A method for tracking the effectiveness of this particular ensemble.

Of these, the Call to Action is considered the most important aspect to influencing the effectiveness of an ad. If we examine the following Dunkin' Donuts mailer we can notice the specific Call to Action being the "Enter for Chance to Win" in the lower left along with the tracking tool, the serial number in the lower right that can be used to track the effectiveness of this campaign.

Figure 19 - Dunkin Donuts Mailer

3.9.2 Web

Most people when starting a business decide to create a domain and web presence. There are several important benefits to this. Over the last ten years, I have seen the web as an effective replacement for the expensive reproduction costs of literature. It has the strong advantage that it can be easily updated without creating obsolete documentation inventories. Most importantly, I have found that building a website encourages the company to undergo a logical process of building information that is essential for doing business. Even if you are not selling your product on the Internet, I would strongly suggest developing a website as a discipline for organizing your customer and employee interface.

An effective website can:

- Establish Customer Credibility
- Establish an email domain address with corporate identity
- Take orders
- Coordinate Returns and Service Calls
- Build mailing lists
- Provide Software Service Downloads

- Provide User Documentation and Training
- Provide confidential document exchange with field personnel or customers
- Recruit Employees
- Obtain Customer Feedback and Promote Customer Exchange of Information

Today's standard is to create literature in PDF (Postscript Descriptor Format) which can be easily viewed on any PC and yet are more difficult to modify in the field.

Building a web presence does not require owning a web server (a PC that is connected to the Internet and is accessed by others who are browsing). There are many domain hosting services available. A typical price would be less than $20 per quarter for an adequate domain for most small companies.

If you are somewhat artistic in nature, tools like Microsoft FrontPage will allow you to simply create and maintain your website design from a PC. The actual files (pages) that you will be creating are stored in HTML format with various extensions in order to achieve specialized effects.

Establishing Web presence involves the following steps:

1. Pick a corporate name and make sure that the domain name is available. There are many sites that will allow you to search to see if a domain name has already been registered and if not, that will allow you to register it for a relatively low fee. You should probably register your domain name with the same company that you choose to host your domain since it is simpler from a billing perspective. It is not however necessary.
2. Sign up for a hosting package. For most small businesses, the lowest cost package is a good place to start.
3. Build your website on your own PC with a tool like Microsoft FrontPage
4. Publish it (upload it to your domain host computer).

3.9.3 Advertising

Advertising is generally used to create leads for your sales organization. Many larger companies will advertise for other purposes including improving or building brand recognition or creating a new product category. However, for most small companies, advertising is directly related to the creation of leads for sales.

As such, its effectiveness can and must be measured by amortizing the cost of a campaign over the sales that it generates. Many techniques including specialized telephone numbers or special offer codes can be used to specifically track a unique part of a campaign.

In general, if you believe that there are many potentially qualified customers out there and you need for them to find you as opposed to you finding them, then advertising can be effective. The key to controlling the cost of advertising is to attempt to match the media as closely as possible to the qualified group of potential customers. For example, if you are selling fishing equipment, advertising in a bass magazine is likely to be more cost effective than advertising in Newsweek.

Advertising media cost is a function of what others will spend for it. For a company whose product is a good match for the particular media choice, they can afford to spend more than others for that media space. Thus, finding the best match between the media and potential customer base is key to getting affordable media. Of course, the specific nature of your margin on your unique product will dictate what you can afford in amortized media cost per sale.

Most advertising firms that I have worked with do not specifically connect to the question of what revenue is generated from a campaign. They mostly have seemed to be more interested in winning peer awards like a Cleo which recognize creativity and style but have no relation to sales success.

It is therefore important for the buyer to be particularly stringent about making sure that the campaign is designed with revenue generation in mind and that a measurement technique is used to prove whether it is successful or not. Do not be swayed by concepts like "we're building your brand or corporate image with this campaign." Sales are what you need.

For business to business advertising campaigns, they mostly occur in either print media, direct mail, or through the web. Direct mail and magazine advertising in trade journals can be very effective for lead generation. However, keep in mind that it only makes sense if it is cheaper than the alternative of identifying your customers directly and simply contacting them first with an outbound telemarketing campaign. Outbound telemarketing is often called "cold calling" especially when done by the sales force.

A good example of a business to business product for which advertising makes sense was in my first company where we designed and built Digital Signal Processors (DSPs). These high speed math accelerators were designed to be added to a computer, by an engineer, to accomplish a performance boost when designing a specific product like a CAT scanner, Radar, Ultrasound, etc. For us, the universe of engineers who were working on such designs at any one time was enormous and difficult to identify. Therefore, we used an advertising campaign in engineering trade journals that would identify our product and its capabilities to engineers who were engaged at that moment in a design process. They would be provoked to contact us and we would then start a sales process.

Alternatively, I am currently helping a company that has designed a machine for reducing the subcutaneous fat in a consumer's legs and thighs. The actual customer for the product would be, for example, a plastic surgeon. In this case, we feel that virtually any plastic surgeon would be a valid and qualified potential customer and we will proactively contact plastic surgeons in an order that is convenient and effective for us rather than to seek to have them contact us. (The order that we are choosing is to go after market leaders and industry pundits first.)

For most small companies, the cost of creating a consumer advertising campaign would be prohibitive through all but some limited media choices like insert ads. However, the advent of a sophisticated infrastructure for direct marketing, whether through television, radio, direct mail or print, gives even the small company the ability to create a brand while creating leads and sales. I will cover direct marketing separately.

3.9.4 Literature

I once was told by a garage mechanic to always wash my car before I give it to a garage to get it fixed. The reason was that the mechanic would base their own attention to detail upon their perception of my level of interest in detail. This is the "telling a book by its cover" concept. I am a great believer that people, and decision makers, base much of their belief system about a company and product upon subtle clues contained in the quality and style of the presentations made either in person or through literature (or the web). Therefore, I am a great believer of making all literature look like you're selling a Mercedes.

Fortunately, the current nature of publishing tools is so sophisticated that it's fairly simple for anyone to achieve a high quality product. An interesting byproduct of this is that it demonstrates how the quality of creativity and artistic design has become more important to the success of any product, both consumer and business to business.

When designing a piece of literature for your product you should attempt to include each of the following:

- A clear statement of your product's value along with the benefit associated with that value
- A competitive matrix which emphasizes the positional advantage of your product in comparison to the competition.
- Some detail about your company, its mission and other offerings.

3.9.5 Public Relations

In general, the concept of public relations is to attempt to use the editorial pages (or television shows) to deliver your advertising message. PR has a cost associated with it and should be directly compared to advertising in its ability to generate leads. PR is usually thought to be a relatively cheap way to "get the word out" for a new product. However, the costs associated with actually doing PR or retaining a PR firm are not trivial and unlike advertising, once a particular new product editor publishes something about your product, that section is not available to you again until you have something new to launch.

Most advertising agencies will suggest that you mix advertising and PR to maximize your message saturation. While I agree in principle, I also think that one must be relatively hardnosed about making sure that the simple measured cost per lead is in fact less when spreading some marketing funds around PR as opposed to advertising.

Everyone dreams about getting Oprah to talk about their product and let there be no mistake, Oprah has the power to make a product. My simple advice is that you not count on her getting excited about your product. However, a good PR firm with good connections can be effective in getting you media exposure. The keys are how good your product is and how good their connections are.

3.9.6 Trade Shows

I am not a fan of trade shows, with one major exception that I outline below. What I tend to find is that companies spend an enormous amount of money on them and that the same leads could have been generated for far less through less flashy methods. However, many people believe that one's presence at a trade show is essential to be taken seriously in a market as a new entrant. And, I must admit, that every one of my companies has attended trade shows and has attempted to follow up the leads gathered to create sales.

Therefore, my advice would be to intentionally go slow when it comes to increasing your tradeshow budget. I would want to leave customers with the impression that things are going well, but I would not try to compete with other more established companies by out “blinging” them at a show.

Unfortunately, most of the talk at tradeshows is what I’ve heard referred to as “happy talk.” Conversations with customers are too short and there are too many distractions to attempt to bring a sales pitch to closure.

On the other hand, a trade show can represent a relatively inexpensive way from a cost of travel perspective, to meet many people: vendors, resellers and customers within a vertical market. When your product innovations are not dramatic for the industry at large, I have found that it is often better and cheaper to rent a hotel room for meetings near a trade show and then to call and schedule meetings before hand with all of those that I would like to meet at the show. Often, in these cases I have even not bothered with actually attending the trade show venue. The net benefits are: it is significantly less expensive, the meetings are more formal with fewer distractions and you still get the benefit of saving travel costs.

3.9.7 Product Launch

Alternatively, if your new-to-be launched product is a dramatic shift for an industry and would garner significant attention by both customers and the trade press then, a trade show can be of significant benefit for public relations and lead generation.

I would strongly recommend attending trades shows if this is the case for your specific innovation. I would then suggest, not attending in future years unless you had similarly impressive innovations.

In any event, the accumulation of all trade show costs, and the amortization of those costs of sales generated will yield a customer acquisition cost that can and should be directly compared with alternative methods. Thus, a rational basis of deciding whether to use a trade show should be possible after an experiment.

When launching a product, you should be creating a launch plan that outlines all of the various pieces needed to be ready to engage with customers. For example, you should be preparing:

- Web presence
- Literature
- Channel and distribution plan
- Lead management system – advertising plan
- Sales process
- Pricing policies including reseller pricing

- Service and warranty policy and spares if appropriate
- PR publication list and press release
- Trade show plan
- Manufacturing schedule

One needs to find a balance between the fervor with which you create and pursue leads and the capabilities of your organization and manufacturing line. For example, it would be pointless and a waste of money to create more leads than your sales organization could handle, or more sales than your manufacturing organization could satisfy.

3.9.8 International Marketing and Sales

My experience is that for high technology products, half of my market was in the US, and half was overseas. In general, overseas buyers who are purchasing technological products designed in the US would rely heavily upon both international trade shows and international representatives to handle the products. Depending upon your own product, this may or may not be true. As a general rule of thumb, for developed countries, a comparison of population size to the US can serve as a first order guess as the potential market size for each company.

The advent of the Internet has changed international selling somewhat. It used to be possible to isolate various parts of the world with your pricing strategy. Now, everyone knows what it costs everywhere. Customers would not be adverse to buying and importing on their own in many cases. As well, resellers can source products overseas and import them on their own.

For most products and for most countries except for Canada and Mexico (which are excluded under NAFTA), there are still complicated import and export restrictions and duties that must be dealt with. In some cases, export of certain technologies is restricted by the Department of Defense (DOD). You will need to clarify both your product category according to the US Dept. of Commerce and the duties when importing that type of product into each country that you want to sell into as well as the US DOD restrictions that might apply. In addition, there are different technical conformance issues for different markets. For example, for the most part, electronic products need FCC approval for distribution in the US and different EC testing and approval for distribution in Europe.

In general, when selling overseas, you will be dealing with a number of resellers who will buy the goods FOB (Freight On Board – meaning the place in the world where the shipment originates) US (or wherever you manufacturer is located) and will deal with the local duties, shipping and insurance responsibilities. It should be possible for you to sell in US dollars only, payable with a check or wire transfer drawn on a US bank. This will enable you to avoid dealing with currency fluctuation issues that are addressed by larger companies.

Your resellers will often take your advertising, literature, user's manuals and other documentation and translate them into local languages on their own.

Small businesses always run a greater risk of fraud when selling overseas. These days, Nigeria has become the white collar crime capital of the world. They have numerous scams including payment with stolen credit card numbers, the offer of multi-million dollar commissions to a US based assistant for the disposal of 23.7 million dollars currently held up in probate or stashed in an offshore bank, bad checks both business and certified, etc. In general, I would suggest avoiding taking any orders from third world countries regardless of how attractive they might look.

With established foreign resellers the terms of payment should still be either a standby letter of credit which is payable upon presentation of the shipping documentation or payment in advance by check or wire transfer in US dollars drawn on a US bank where shipment will not be made until the funds are proven good. Foreign bank checks can take a long time to clear (or bounce). You should make sure that funds are collected before shipping.

Keep in mind that if you accept a bogus credit card from an international customer, even though the credit card clearance agency has told you that the funds are good, you are liable for reimbursement to the credit card agency when the card is discovered to be fraudulent. This is because you are responsible for checking the identity of the cardholder.

It is enticing to hire foreign nationals to serve as a local presence in other countries. However, foreign employment laws are very different than those in the US and you should move slowly and with a clear understanding of your potential liabilities when hiring overseas. As well, it is often quite difficult to really read someone who has had a different cultural upbringing when interviewing them. You should seek the help of local recruiters for both the interview and reference checking process.

Finally, as a note of caution, when traveling overseas it is often desirable to bring samples. There is a legal, but somewhat cumbersome method to do this. It requires a Carnet which is applied for with the customs department. When leaving the country, it is necessary to show the goods and Carnet to the customs office at the airport indicating that you are taking the goods out of the country. Note that there is a fee (typically a few hundred dollars) and you will also be asked to post a bond to secure potential duty liabilities. At each port of destination, when entering and leaving, you will again show the Carnet and the goods, thereby avoiding the need to pay duties. However, you are not allowed to sell the goods overseas and you must return with them at which point you can collect your bond.

If you do not use a Carnet, you run the risk that either the goods will be seized by a customs officer of a country that you visit or, alternatively, if you declare the goods upon entry, that you will be required to pay duties before being able to bring the goods into the country. More information about Carnets can be easily found online: http://www.uscib.org/index.asp?documentID=1843

Of course, if you have selected a reseller within a destination country, simply send the samples ahead and let them deal with paying the duties for import.

3.9.9 Lead Generation

In general, all of your marketing efforts, whether advertising, attending a trade show or outbound telemarketing, should have the defined purpose of generating leads for your sales process. It is essential that you measure their effectiveness with a uniform standard of the cost per lead and the cost per sale by amortizing each campaign over the leads and sales that it generates.

Later on, when I describe the sales funnel or pyramid, the lead generation process is the beginning of all sales efforts.

As your company gathers leads either through the mail, web or telephone, you will be creating a lead management process that will:

- Gather the customer information for later outbound marketing
- Pass the lead into the sales process, or
- Pass the lead on to a domestic or international reseller

Your most valuable database is that of both customers and potential customers. Often, companies use warranty registration or discount coupons as a method for gathering specific customer data. Customers are pre-qualified for many of the attributes that you need for future product sales.

In the beginning, all potential methods of lead generation should be considered. It is only through testing that you can determine the cost effectiveness of any particular method or media type and it is only through constant monitoring of the performance that you will be able to understand how best to invest your marketing dollars for lead generation. In the end, the goal is simply to buy sales as inexpensively as possible.

In 2005 the following direct marketing survey of performance was generated by the Direct Marketing Association. It indicates both the average response rate, as well as the cost per contact and the return on investment. Note that this was for direct marketing campaigns and not for advertising which might lead to sales through other fulfillment channels. It is a good comparison of the relative cost and performance of different media types.

	Revenue Per Contact	Promo Cost Per Contact	Average Response Rates	ROI Index
Telephone	$45.37	$2.50	5.78	18.2
E-Mail	$1.60	$0.10	1.12	16.0
Dimensional Mail	$14.16	$0.91	2.30	15.3
Direct Mail	$11.36	$0.56	1.88	14.9
Newspaper	$0.45	$0.05	0.09	8.80
Coupons	$1.50	$0.23	1.65	6.50
Catalog	$1.48	$0.69	2.18	6.40
Inserts	$0.49	$0.14	0.45	3.50
Magazine	$0.22	$0.11	0.13	2.00
Free Standing Inserts	$0.12	$0.07	0.13	1.60
Radio	$0.08	$0.07	0.10	1.20
DRTV	$0.02	$0.03	0.04	0.70

Figure 20 - Direct Marketing Association Performance Report

A relatively simple method of lead generation that we can look at in a bit more detail is the use of Google's Ad-Words. I am certain that you are familiar with the Google search engine on the web. On the right hand side of each presented search results page are "paid for" advertisements that are also contingent upon the terms being searched.

Advertisers basically select a set of key words that they believe are associated with their product, and then they bid on the placement or their ad in the list. A first place might cost $0.20 while a placement of fifth might cost only $0.05.

However, the cost of placement is only incurred if the user actually "clicks through" by selecting your ad. This will link the user to your selected page where you have the opportunity to sell your product.

The Google lead generation model will be covered in a bit more detail in the Direct Marketing Section.

Internet campaigns like this have the exceptional advantage that they are precisely measurable and infinitely controllable. For example, you can choose to have two or more different landing pages with different offers, possibly different prices, and you can measure the precise statistics of the number of customers that close at each price point.

The Internet, along with tools like Google Ad-Words is a fantastic sandbox for tuning a campaign. The only disadvantage is that not many people actually purchase products today through this channel. Thus, after tuning a campaign, it is still necessary, if you want to expand the lead and sales base, to move on to other media types for lead generation.

For most companies, the process of lead generation is multi-tiered. First, you are confronted with generating leads of potential resellers. These are your first customers. Your value proposition and marketing activities are aimed at generating these leads and selling to them. In most cases, trade shows, or direct outbound telephone cold calling is most effective since you can easily identify the most desirable resellers for your category.

Second, it is often necessary, especially if you are attempting to create a new category, for you to create end-user leads which are either passed along to your reseller or directly result in somehow establishing contact between your reseller and the end-customer. For some products, especially if the category is well established, there is no need other than through in-store marketing techniques, to advertise your product or brand to end-customers.

3.10 Pricing

There are a lot of religious beliefs when it comes to pricing and several entire books written on the concept.

Small company product pricing is a bit different than large company pricing and is based upon two premises:

First, as pointed out by Duncan Miller in his Heatspring interview, “the market is not very efficient [for small companies] and for the most part your actions go undiscovered by virtually everyone.” As a result, you can change pricing models fairly easily without worrying about the impact on other new customers.

I’ve heard it said, for example, that it’s easy to go down, and impossible to go up. My attitude has been, you can go anywhere you want and when you want, while you’re small.

In the end, the best advice that I can give is to understand that your customers don’t really communicate with each other efficiently and it’s OK to try different prices, even at the same time while attempting to find the right price point for your product.

Second, as described in the first section of this book, in the beginning, cash flow is king. Thus, higher prices and the expectation that you will have a smaller market is quite consistent with your needs when you’re small.

For small companies, pricing should be a function of the strength of the value proposition, or what is referred to as “value pricing.”

Products that save people or companies money are often priced according to the payback period based upon cumulative savings. For example, a payback period of one year is considered excellent.

Products that make money for your customers can be priced based upon their margin expectations.

The most important aspect of your own pricing is making sure that you are making a profit. All too often, entrepreneurs are unfamiliar with the real cost of customer acquisition or brand building and they therefore do not leave enough margin to pay for these marketing efforts. As a rule of thumb, in the direct marketing industry, the selling price is often more than five times the cost of the product. Half of every revenue dollar goes directly into advertising media cost.

So, in summary, start high, way high, you’ll probably need the extra margin and you probably won’t be able to handle the deluge of customers if your product is too cheap in the early days. Keep in mind that early adopters are generally willing to pay more and that it's an essential test of your value proposition to make sure that you're being paid adequately for your product's value.

I have frequently advised and seen small companies successfully experiment with pricing by starting with an arbitrary price, and then, if a sale is closed with relative ease, raising the price systematically until there is push-back from the customer. Using this, I've seen a price of one young company's product double before it stabilized, thus offering a considerable margin advantage to the company.

3.10.1.1 The role of zero in consumer decisions

In his book "Predictably Irrational," Dan Ariely has several interesting experiments that involve the use of zero price offerings in comparison to other offers in order to better understand how the consumer comparatively values products.

One of his most interesting experiments involves a choice given to consumers between a $0.15 high quality chocolate and a $0.02 Hershey Kiss (a presumably lower quality product). After observation of the behavior of his consumers, he lowers the price of each by $0.02, or equivalently making the Kiss free.

While one might expect a somewhat linear response that correlated with the proportional reduction in price, instead what he observed was a radical shift to the free Kiss implying that when one reaches zero, there is a discontinuous jump in perceived comparative value that reaches beyond logical analysis.

This is not a surprising thought when one looks at the methods used by TV infomercials in offering "free" gifts for making the purchase. It is interesting nonetheless to confirm this behavior in a more scientific setting.

3.11 Retail Distribution

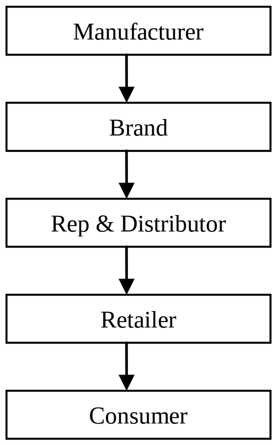


Figure 21 - Retail Sales Chain

There are many channels that are used to sell consumer products. They include: brick & mortar retailers, the Internet, television and radio direct marketing, television shopping channels, catalogue direct sales, and door to door multi-tier selling organizations. Each is different and needs to be understood to be used effectively.

In general, every retail channel has the opportunity to sell any product that they would like. The value that a retailer ascribes to a product is simply related to the profit that it affords over time (and in some cases, space.) If your goal is to develop a product, then you need to learn to relate to the profit goals of the retail channel. Alternatively, if your goal is to become an alternative retail channel, your goal is to find products that afford you the maximum profit for your own efforts.

When selling products to retailers, in most cases, you will actually be selling your product to a distributor who will, in turn, deliver the product to the individual retail stores for resale. Some large retailers have their own internal distribution systems. Thus, you must deal with the value proposition for both the retailer and for the distributor. In general, you will later see that around 50% of every sales dollar will go to the retailer, rep, distributor, advertising support or other cost which is related to channel support.

3.11.1 Buyers, Reps and Distributors

The role of the distributor is to stock inventory and ship to individual retail sites in small quantities as product is sold through. Some large retailers have their own internal distribution facilities.

The rep serves purely a sales role and does not typically stock, ship or resell your product but rather, makes a commission for supporting the distribution of information about your product. Reps typically are regionally located and handle many products for a few retail buyers.

Retailers have buyers whose responsibility is the selection and negotiation of supply of products for segments of a store. Stores will frequently rotate buyers so as to prevent cozy relationships with vendors that may not afford the retailer the best terms. Buyers are also responsible for selling cooperative advertising to their suppliers. Advertising can consist of in-store signage, newspaper inserts or preferential shelf placement. A buyer's own salary compensation will be often tied to the profit per shelf foot and profit per advertisement.

Buyers will select products by attending trade shows, reading trade press, talking to sellers or their reps or by seeing the product in a competing store. A buyer is concerned with both the profit generated by the product as well as the potential it has for drawing customers into the store.

3.11.1.1 Buyer Trade Shows

Buyers will often attend industry related trade shows for their specialty. An excellent example of retail buyer trade shows are the ECRM standing for "Efficient Collaborative Retail Marketing" events. These are a series of smaller trade shows that occur several times per week and are focused upon specific categories or retailers. For example, there is a Photo and Electronics event, and a Private Label Health & Beauty Care event.

These shows are paid for by the vendors and give vendors and their related buyers a structured and efficient environment to present product lines and begin the commitment process. If you are considering selling a product through retail, the ECRM meetings can be very useful. I would strongly suggest visiting their website and viewing their tutorial videos in order to better understand their process.

3.11.2 Retailer's Vendor Requirements

Each retail store will have specific terms and conditions that they expect when dealing with product suppliers. These vendor requirements will specify in great detail everything from the size of pallets or multi-packs to be used to the acceptable packaging and markings. Retailers will provide you with a vendor requirements document early in the process.

Vendor policies will typically include:

- Acceptable product packaging
- Service and return policies
- Financial requirements (D&B)
- Transaction methodology (Electronic invoicing, etc.)
- Labeling requirements
- Quality assurance requirements
- Discounts for non-compliance
- Planning and forecasting methods

- Regulatory compliance requirements
- Shipment methods, pallet sizes and labeling

3.11.3 Retail Packaging and Pricing

You will first need to obtain a UPC (Universal Product Code) for your product. This can be done over the Internet quite inexpensively.

Buyers will often express interest in the packaging for your product and will have their own opinions about what it should look like. Keep in mind that in most cases, your packing will need to conform to category packaging constraints imposed by the retail store. For example, the size and whether it is peg or shelf mounted will be defined for you.

When you approach a buyer with a new product, the buyer will ask you to suggest a price and volume. They will be able to tell you what other participants in the category are currently doing, but they will look to you for estimates for your own product. Note from the chart shown that approximately 50% of your retail price will be absorbed by the costs of doing business with the channel.

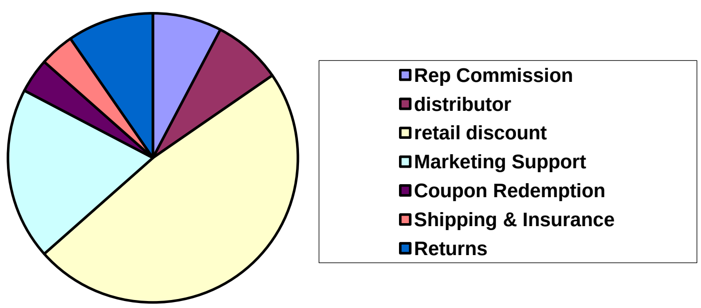


Figure 22- Retail Price Components

The retailer will monitor the actual sell-through for your product on a daily basis and will re-order as necessary in order to maintain a minimum inventory that adequately meets the real sell-through for the product. If product does not sell, then the buyer will suggest more advertising (to be paid for by you), a lower price, or a discontinuation and return of unsold inventory. It is your responsibility to generate consumer pull for your product.

As well, retailers will expect that you will protect them when new models are introduced by taking back older models in inventory in exchange. They will also want "exit strategy" support when the product is going to be discontinued.

You may be required to obtain your own EDI system for issuing electronic invoices and receiving electronic purchase orders. Relatively inexpensive web based systems are available, or your distributor can handle these processes for you.

For vendors with large product families, they will be asked to provide entire Plano grams that define the entire shelf layout for their products.

3.11.4 Package Design

If you are participating in a pre-existing category, then the package design goals should include:

- Share Shifting Differentiation
- Easy brand identification
- Easy sub-category identification
- Attract attention
- Create a call to action

Alternatively, in a new category, the package may range from entirely unimportant (a simple brown box) because the sale is being conducted through direct.

When starting with a new product for a new company in a pre-existing category, the first and foremost job of the package design is to establish the differentiation that is hoped to produce a share shift while reinforcing the expected values that enable you to participate in the category. This is a common error made by students. They often highlight the name of their new company or the name of the product where the name has no descriptive value.

For example, if your product is the first razor to have three blades instead of two, then the largest and simplest print must proclaim: “THREE BLADES” or “THE ONLY THREE BLADED RAZOR.” In addition, it is enormously helpful if the product name supports the differentiator. For example, the name of this razor might be the “TRIPLE BLADE” or “TRACK 3.” A consumer has only a second or two to focus on your package and “get it.”

For more established brands, brand identification can be accomplished through a common color scheme or shape. For example, Polaroid used the shown package designs on all of their products.

Subcategory identification can also be accomplished through color, a good example being the use of color coded screw tops on orange juice containers to indicate which have calcium added, or no pulp.

Package designs can also be especially unique in order to attract attention on the shelf.

Figure 24 - An award winning design

Figure 23 - Polaroid example of brand packaging

Finally, package designs like all other forms of advertising, will often use a call to action to (CTA) to also influence shift share. This usually appears in the form of a special offer of either additional free product, a discount or rebate.

3.11.5 Brand-Manufacturers and Contract-Manufacturers

Note that I am making the distinction between contract-manufactures, for example a Chinese company like Ngai-Lik, which is a typical high volume, low cost, manufacturer of consumer products and a brand-manufacturer, like Sony that manages their own brand and manufacturing processes.

Brand-manufacturers typically invest in research, development and marketing that builds brand and product awareness. They typically rely upon retail enterprises to manage the fulfillment process including returns. In the current market, most brand-manufacturers sell product to their retail distribution partners under terms that are closer to consignment than actual sale. Thus, the brand-manufacturer assumes the risk of poor pricing or poor sales. Additionally, the brand-manufacturer extends the payment terms to the retailer and thus finances the inventory.

Alternatively, contract-manufacturers in Asia or other low cost manufacturing areas will build products to be marketed under the brands of others including brand-manufacturers or directly for retailers who will sell under their own or generally unrecognized brand names. These contract-manufacturers typically add very little value to the manufactured product. The selling price for a consumer product from a contract-manufacturer might be typically only 10% to 15% over the cost of the bill of materials. This would pay for component procurement, assembly, test, and packaging and provide the contract-manufacturer's profit. As such, their limited margins limit their ability to assume risk or invest in development. The terms of sale are usually LC (letter of credit) which ensures payment upon demonstration of shipment by the contract-manufacturer. The brand-manufacturer or retailer who is their customer typically takes possession of the product at the loading dock of the contract-manufacturer with no recourse of return except in the case of warranty failure.

Retailers feel extraordinary pressure to reduce retail prices. As such, they offer little or no sales support, customer education and are often, like Wal-Mart, driven to attempt to offer store branded products that are sourced directly from Asia, but only when sell-through is clearly understood so that there is no risk assumed by them for product that doesn't sell. Note that when retailers buy directly from contract-manufacturers, they lose their ability to return unsold goods or renegotiate prices as they do with brand-manufacturers.

When a brand-manufacturer is removed from the chain, by having the retailer buy directly from a contract-manufacturer, there is the loss of an important aspect of the prior business model. The product development and innovation that was paid for by the profits accumulated by the brand-manufacturer will no longer be done. For markets where there is no substantial innovation requirement, Wal-Mart's strategy of squeezing the brand-manufacturer out will have no detrimental effect, except, of course to the brand-manufacturer. However, for product categories where further innovation is required, Wal-Mart's actions will only result in the inability of the brand-manufacturer to pay those costs and thus innovation will be stifled. Note also, that a lack of innovation in a particular market to some extent benefits Wal-Mart in that their inventory management becomes simpler since model transitions do not occur. However, it also hurts Wal-Mart by eliminating the early obsolescence of products through innovation and possibly more-so by eliminating the manufacturing jobs in the U.S. that enabled people to buy these products.

Today, a new challenge to this business model is coming and possibly even the mighty Wal-Mart can be threatened.

This won't be the first time, or the last where technology has forced a major company to change strategy or die. For example, this transition will likely be similar to what is happening to Kodak as a result of the creation of digital cameras. Kodak's vast infrastructure, and capital base is highly dependent upon the need for film and with film's demise, the burden of their enormous infrastructure may be too much for them to shed. It is possible that electronic forms of shopping will have similar effects on the brick and mortar investment of companies like Wal-Mart.

3.11.6 Brick & Mortar Retail Trends

Twenty years ago, manufacturers with strong brands ruled retail. They could define pricing and retail strategies assumed by their brick and mortar retail fulfillment agents. Today, for many products, the retail distribution world has turned upside down. Retailers, namely Wal-Mart, currently the world's largest company, rule the roost and manufacturers jump to their requirements and directives. The result is always a reduction of the brand-manufacturer's margins with the penalty of exclusion from distribution if they resist. Rubbermaid is a case in point. Their resistance to forced price decreases imposed by Wal-Mart resulted in important Rubbermaid product lines being dropped, and a resulting reduction in their revenue and profit and the eventual demise of the company. An excellent review of this case is available in a PBS "Frontline" report titled: "Is Wal-Mart good for America?"

For the most successful product categories, eventually, retailers like Wal-Mart will source a generic or store-branded version of a product directly from Chinese manufacturers after the risks of market development have been paid for by former leading brands. This results either in Wal-Mart assuming higher margins or the consumer being able to purchase the product for less or a combination of both. Clearly, today, Wal-Mart controls, for many product categories, the channel distribution. Even weaker retailers today will assume no risk when purchasing shelf inventory and will only pay for product once it sells through. Stale product must either be discounted by the manufacturer in an attempt to move it off of the retail shelves or it is returned to the manufacturer for credit.

Retailers can be considered to be direct marketers of sorts. Their media ratio is measured on the effectiveness of shelf space including the cost of its support services. From the retailer's perspective, their goal is to maximize their profit given the limited shelf space that they have. If they could simplify their inventory they would. However, similar to the direct marketing channel, they find that increasing the shelf space of any particular product may not be as profitable as bringing in a different product. It is this analysis that gives current large retailers like Wal-Mart tremendous leverage in that they really don't care if any particular product is or is not being sold.

This leads to the question: are any products or brands safe from being taken over by house branded, Asian manufactured product? There are several factors that stifle this tendency. First, some products are just too costly to ship from overseas because their weight/value ratio is low. For these products, American sources will continue to dominate.

Second, some products require the creation of an infrastructure that is beyond Asian companies. Finally, some brands are quite strong and national advertising continues to support the brand differentiation. Lower priced, retail versions of the product cannot afford to support such advertising campaigns. However, the retailer will constantly test the value that the consumer associates with the brand alone, in these cases, by offering store branded equivalents at lower prices. Ketchup and cola are good examples.

We are all familiar with retail stores. In some ways, the ice cream truck is an example of one extreme case of retail distribution. It has a single product and only enough shelf space to show one customer what is being offered. The customers line up and pay with cash. Retailers would generally like to reduce the complexity of their inventory. However, at some point on the way to minimization, customers wouldn’t come due to the lack of selection unless the remaining products had tremendous appeal.

Retailers have come to appreciate their business model as being simply attempting to maximize the return per linear foot of shelf space. To the retailer there is the constant battle of minimizing the alternatives within a category to only those that create adequate revenue per foot while keeping enough alternatives so that shoppers are encouraged to come to their store for a choice within a category.

Retailers don’t really care what products are sold so long as they maximize the shelf return.

Most large retailers use a staff of buyers to select products for resale, and to negotiate the pricing. As well, buyers are often charged with the task of selling advertising which can be in the form of in-store advertising or inclusion in print advertising, for example a Sunday newspaper supplement. The buyer’s success is rated upon his/her ability to maximize the profit for the shelf space that he/she controls plus the profit on advertising supports.

Buyers are often rotated within a large company to prevent or at least decrease the likelihood of gifts or payoffs being used to influence a buyer’s decisions. Clearly, these are considered not to be in the interest of the buyer’s employer and therefore are often grounds for dismissal.

Buyers will most likely have no valuable position on whether a new product can or will sell and at what volumes. Buyers can, however, provide critical information about their current sales levels within the category of your product. They can also give real results for advertising that is currently ongoing.

When a buyer purchases your product for placement, there is no commitment assumed by the retailer to actually pay you until and only if your product sells through to the end consumer (and isn't returned). You may believe that the purchase order that you just received is "as good as gold" but the reality is that you will continue to own the inventory, in spite of the wording of the purchase order, until the customer buys your product.

When you understand these issues, it becomes clearer to you that when the buyer says: "so how many of these do you think we should sell per week?" that an optimistic response by you might not be in your best interest. Some stores have programs for the introduction of new products through one or two individual stores to accumulate sales records before launching on a national or regional basis. In general, new, small companies should take advantage of these opportunities in order to reduce the risk of inventory.

This raises an important issue for most small companies. Often, the ability to manufacture a new product is not in question. But, rather traction in the market is unknown. As well, there is often a large financial risk assumed to build enough of a new product to get the cost down to a reasonable level. However, the key to understand is that it isn't necessary to make a profit from the first few sales while developing an understanding of the real sell through nature of your product.

In simpler terms, it is often wiser to build a few, albeit at higher cost, and use them to test the real market opportunity, even if the cost makes the sale at your desired price a losing proposition. There's plenty of time in the future for you, once you understand the real market dynamics, to manufacture in higher quantity and achieve the costs and profit that you desire.

Retail distribution is really well suited to established categories. The net result, therefore for bringing a new product into the market is to cause a share shift. Innovation in product is constantly shifting shares within a category. As well, price variations are used to shift shares. To the retailer, the shifting of share is at best irrelevant, at worst, the cause of loss of revenue because of the waste of shelf space for product that isn't selling.

If you are successful shifting category share from your competitors to your own product, they are unlikely to simply sit by and watch. The result can be eroding pricing since price can be most easily used to attempt to shift share back. In some cases, large cash rich companies have the ability to sustain losses until competitors are encouraged to leave a category. This has been notorious in many markets where

Japanese manufacturers with government supports, targeted particular categories and held prices low until domestic manufacturers exited the market. The lawnmower business is one good example.

Causing share-shifting within a category is not simple. The package design is your primary source of advertising and it generally is not a lot of space and doesn't get a lot of attention. Cleary, price can easily and quickly be absorbed by a consumer for shifting share. However, technical innovation is far more difficult to express quickly and unambiguously in your package design.

Package design becomes one of the most critical aspects to launching a successful retail sales campaign. Often, inferior products at higher prices can be preferentially sold merely through a better package design. The keys to good package design are:

- Eye catching – customers are browsing quickly when shopping
- The specific differentiating value proposition must be made clearly
  - This includes what the contents are (they can be shown)
  - What is unique about this category participant
- The call to action or special offer

Different retailers will have different expectations in the packaging for a particular category. For example, if you want to sell cables in a computer store, you would be expected to hang your product on a peg and only occupy a maximum space defined by the retailer. It is essential that you understand your retailers preferences for your category.

Some of the best manufacturers, like Belden, will bring their products into a retailer by first: photographing the retailer's current product presentation for the desired category and then redesigning the entire space so as to fit more products and more importantly, create more profit per linear foot.

Buyers will react more to your packaging than to your product. They will often have their own opinion about how you can improve your packaging, but keep in mind that they are not package designers. Package design is a skill and professional designers can improve sales for their clients.

Buyers prefer dealing with the fewest manufacturers possible to meet their shelf requirements. They prefer this because it simplifies their life, but more importantly, because it increases their leverage to get accommodations from the manufacturer.

When a particular product does not sell through to the consumer, the buyer will typically offer that most likely, the price is too high. He will offer to the manufacturer, the choice to either reduce the price (and cost) of the existing inventory or simply take back the failing product. Neither choice is particularly attractive to the manufacturer but that is the reality of retail selling through brick and mortar retailers.

In recent years, Wal-Mart and a few other retailers have been so successful that they have garnished the opportunity to launch their own branded products through their stores in competition with their suppliers. Often the brand name is simply made up, or it's store branded. The product will often be manufactured by an OEM or Contract Manufacturer directly for the retailer thereby cutting out the role and profit normally assumed by the brand.

For product categories that do not require a lot of innovation and development cost, this can be catastrophic for the original brand.

3.11.6.1 Wal-Mart and Coke

As another example of the growing strength of retailers, in 2005 Coca-Cola wanted to introduce a new product called Coke Zero but Wal-Mart didn't quite like their plan. Wal-Mart had previously established that their shoppers and especially women shoppers preferred products containing Splenda as opposed to aspartame the preference of Coke. Given that Wal-Mart is the country's largest food retailer, with almost 2000 supercenters in the U.S. and represents 14 to 18 percent of all food and beverage sales[21], Coke rethought their plan and instead introduced Diet Coke with Splenda. Coke launched Coke Zero later on as a different product.

In addition, Wal-Mart has been urging laundry detergent manufacturers to produce "super concentrated" versions that would require less shelf space and handling cost.

3.11.6.2 Slotting Fees

Retailers will typically charge new vendors "slotting fees" that permit the new vendor to place their products onto the retailer's shelves. These fees can be quite high, typically as much as one million dollars for a national chain.

Oddly, in the interest of attracting new smaller companies with innovative products, these same retailers will eliminate the slotting fees for smaller companies.

This has two important implications. First, it leads to the opportunity for smaller companies to introduce and experiment with new products through conventional retail channels. More importantly, a small

[21] Source - Retail Forward, a retail research firm in Columbus, Ohio and New York Times

company that has successfully launched their products through national retail chains has a tremendously valuable asset, the slotting agreements, which make the acquisition of the small company by a large company quite appealing. For example, successful slotting in ten retailers might justify a ten million dollar minimum acquisition price simply based upon the savings in slotting fees.

3.11.7 Seasonal and Time Related Issues

Successful distribution strategies must be cognizant of both the seasonal cycles of distribution as well as the normal process delays involved in obtaining commitments and delivering product.

Forty percent of all retail sales for consumer products that are not related to food or essential items are sold within the last quarter of the year. The remaining sixty percent are pretty much distributed evenly over the other three quarters. Thus, a successful holiday season is essential to most product strategies.

Launching a product can take years since retail commitments for a holiday season are placed well before the preceding summer. For example, products shown at the January 5-8 CES (Consumer Electronics Show) are for the following holiday season. All product deliveries will need to be in the inventories of retailers by the end of that summer.

Attachment D contains the product schedule for the Pixifun product created and launched by Pexagon Technologies of Connecticut. This product contains many interesting lessons about the difficulty of attempting to create a new category product, but of particular interest is to note the length of time needed from when in the fall of 2003, the product was ready for samples until February of 2005 when Pexagon first understood that the actual sell through was disappointing. Keep in mind that Pexagon had some leverage with each of their retail partners and was able to get them to be far more patient with the product than might have been possible for a new start venture.

3.11.8 If you're the Retailer – Improving Sales

Some of my students have opened their own retail stores selling products ranging from pharmacy items to arts and crafts. Frequently, their problem is how to improve their revenue and profitability. Often, they have not applied any statistical analysis to their own shelf space. Essentially, there are two principal problems for retailers: attracting potential customers to your store and maximizing the profit per customer. As in the case of direct marketing with lead generation and telemarketing components, these, while interrelated, can be approached independently at first.

Typically, attracting customers involves the combination of advertising with a compelling call to action. Stores like Wal-Mart use their “price point leader” as their advertised draw. Often, these products are available at unusually low prices. However, Wal-Mart depends upon selling the customer up from what would be an unprofitable sale. In the old days, we called this “bait and switch.”

However, there are many more savory approaches to creating compelling calls to action that can bring customers into your store. The key is to measure the success of campaigns and reinforce those that appear to be successful.

The second part of the problem, increasing the revenue per customer, can be approached through analysis of the sales and profit per foot of shelf space or floor space. The key is to discard products that do not provide adequate return and to replace them with other products, potentially in categories that are known to be more successful within the store. For example, if you’re succeeding with your tea sales and not with your soft drinks, then reduce the shelf space for soft drinks, potentially to zero and increase your tea selection or products related to tea. There must be a constant reassessment and adjustment to your inventory to maximize your revenue.

As well, product placement within your store is important. As demonstrated by larger retailers, the ends of shelves and areas near the cash register are premium and should be used for spontaneous high volume purchases. I strongly encourage you to experiment outside of what you believe is your category. For example, consider greeting cards even if you’re not in the card business. Most large retailers create a target for revenue per foot of shelf that they constantly monitor and attempt to improve.

3.11.9 Direct Marketing

Today, the term "direct marketing" most likely brings to mind late night television infomercials and a resonant voice saying: "but wait, there's more." In fact, direct marketing is the new frontier in consumer distribution and technological advances including satellite and cable TV, the Internet and faster computers are expanding this channel rapidly.

As well, most B2B sales follow the direct marketing model with lead generation followed by telephone pre-sales and person-to-person selling to close the sale. This is covered in more detail later on in this chapter.

Direct marketing is a game of statistics. I've had many conversations with uninitiated marketers who can't quite imagine "someone opening a direct mail piece" or "watching an infomercial." When one airs a 30 minute television infomercial at 3:00AM to over 30,000,000 households and a mere 100 people call in and 80 buy, it's hard to understand the logic behind the process. It gets even more difficult to understand when one runs the same infomercial in the same 3:00AM slot week after week and the number of new callers and buyers per week is virtually identical. It seems somewhat counter intuitive. But, that's the way it works. It's based on a "law of large numbers" where the statistics are relatively uniform.

Direct marketing has many individual and separable components (lead generation, closing, fulfillment and returns) which are similar and independent of whether the campaign is carried out on television or through the mail.

Internet direct marketing is a relatively recent innovation. Most direct marketers have not yet figured out how to properly integrate an Internet campaign together with other forms in order to reduce risk as well as improve profitability. One of the short term opportunities in direct marketing is to innovate with this integration.

3.12 The Direct Marketing Model

Back to direct marketing. First, let me define what is meant by the term: direct marketing. This is a distribution channel where the manufacturer sells directly to the consumer with no middle-man. There are many forms of direct marketing including: television and radio infomercial, print advertising, direct mail, email and Internet advertising, etc. What sets all of these apart from other types of advertising is that the consummation of the sale is done directly between the consumer and the manufacturer. This is unlike, for example, Coke advertising, where the purpose of the ad is to build brand awareness and drive the consumer to any of thousands of retailers who can offer the product.

There are several advantages to direct marketing in comparison to more conventional forms of retail distribution. The manufacturer gets the opportunity to directly control their own customer lists and return to those same customers with new products and improvements. You will have already observed that once you shop at a store like the GAP, you become targeted for the direct mailing of both the store and potentially the brand-manufacturer catalogs. Warranty registrations are often used as a method of moving a retail customer to a direct marketing mail or email channel that cuts out the retailer for subsequent sales.

As well, the manufacturer can immediately understand the profit and loss statement for a particular product and can take immediate actions to improve it. Managing a direct marketing campaign requires statistical analysis of the results and a constant tweaking of the controls to optimize the results.

In direct marketing, there are several ways that one can evaluate ones success. Typically, one calculates the cost of acquiring a customer in order to understand the relative profitability of a campaign and the comparison to alternative distribution models. As well, direct marketers often refer to the media ratio (the ratio of the revenue divided by the media cost) as a way of directly comparing alternative media.

For example, one can consider a television direct marketing campaign for a gym product. Assume that the product sells for $75, however, because of the nature of direct marketing and the opportunity to up-sell the customer, the actual average revenue per customer might be $100. For a particular campaign, a media slot at 1:00AM was purchased for $5,000. This provided a 30 minute infomercial to roughly 30 million TV sets. All were not on, nor were they all tuned to the particular channel purchased.

The call to action prompted the potential customer to call a toll free number to receive a special offer. For this single airing, 120 people actually got off their couches and called. Of those, 100 were convinced to buy at an average of $100 per sale. Thus, this single airing generated $10,000 of revenue, of which $5,000 was used to pay for the media. In this case, we would consider the media ratio to be 2:1 or 2. The cost of customer acquisition would be calculated to be $50 (100 customers for $5000).

Before you break out the Champagne, one must consider the other costs. Typically, for products offered through direct marketing channels, the manufacturing cost of the product must be less than one fifth of the average selling price, or in this case around $20. The telephone costs average around $0.15 per minute and must be averaged together for both successful and unsuccessful attempts at sales. As well, we must consider returns, bad credit cards, credit card fees, and shipping and handling costs, in order to determine if we really are making a profit.

One important item to note that will grossly effect your cash flow is that the credit card clearing company will hold back a large portion of your revenue until they have either passed the point at which the customer can return the goods and/or ask for a credit back, or after they have enough of a track record with your firm so as to have expectations about what the return and credit rate will be. It would not be unusual for this to be as much as 30% of revenue for 30 days in the beginning of your business.

A more complete profit and loss statement for your product for this particular media run might be summarized as follows:

Item	**Amount**	**Note**
Media Airing Cost	$ (5,000.00)	Includes broker fees
Number of Calls Generated	120	
Number of purchases	100	
Average Sale Value Per Customer	$ 100.00	
Total Revenue for this airing	$10,000.00	
Media Ratio	**2.00**	**= (total revenue) / (media cost)**
Average time in minutes per call	10	
Cost per minute of telephone	$ (0.15)	
Total Telephone Cost	$ (180.00)	
Average Cost of Goods per Sale	$ (20.00)	
Total Cost of Goods	$ (2,000.00)	
Shipping and Handling per Sale	$ (10.00)	
Total Shipping and Handling	$ (950.00)	No shipping on bad credit cards
Credit Card Fees at 2.5%	$ (250.00)	
Bad Credit Cards at 5%	$ (500.00)	these are not shipped
Net Profit for airing before returns	$ 1,070.00	
Returns at 5%	$ (500.00)	Inventory may be restocked?
Total Net Contributory Profit	**$ 620.00**	**=6.2% of revenue**

Don't confuse the above campaign P&L with your corporate P&L which also shows the fixed expenses and other sources of income or expense unrelated to this campaign. The key aspect of the campaign P&L is that it offers the ability to compare one campaign to another in its ability to contribute profit to the corporation. Often, a company will have several campaign P&Ls all contributing to a single corporate profit number.

3.12.1 Dissecting the Direct Marketing Process

In most cases, the process of direct marketing breaks down into two somewhat separate processes; lead generation, and closing. While these are interconnected in important ways, they can also be considered separately. Over the last 10 years, direct marketing has spawned a number of independent sub-contractors who each specialize in one aspect of the direct marketing process. For example, today one can easily find and work with: media buying agents, telemarketing call receivers, and fulfillment houses that are all independent companies.

Most large direct marketing campaigns are not run by product companies but rather by channel companies whose focus is mastering the direct marketing process. You will note when watching an infomercial that it is often unclear or not stated who the manufacturer is. The product stands alone on its name. There are a few exceptions and more recently, infomercial companies are starting to create brands for themselves.

If you have a product and you would like to sell it through direct marketing channels, there are a number of alternatives. First, you can approach a direct marketing channel company and negotiate a royalty deal. Alternatively, you can start your own limited campaign, probably starting on the Internet, and handling those aspects of the campaign on your own until they grow beyond your own capabilities. Finally, you can use pre-existing subcontractors for each of the segments of the campaign.

I cannot emphasize enough the statistical nature of direct marketing and the absolute requirement that the brand-manufacturer be willing and able to monitor the campaign performance and force improvements in each component on an ongoing basis. It is important to keep in mind that each of the subcontractors own optimizations are in many cases directly in conflict with the goals of any one campaign. Their desire is only that you continue to run the program, not that you make a lot of money doing so.

For the direct mail industry, in some cases, printing companies now have the ability to create campaigns, buy lists, create artwork, and mail the pieces. Also, one can find advertising agencies that have grown to specialize in direct marketing and will sub-contract the printing and mailing but will take on the list procurement and creative aspects of the project.

We are now starting to see the development of television direct marketing "one-stop" companies that are simply looking to source product and will handle all of the aspects of creative, media purchase, telemarketing, and fulfillment. In some cases, a product inventor can simply license a product to a television direct marketing company that will invest its own money in the creation and testing of the campaign. If successful, the inventor will simply be paid a royalty for each product sold.

A more recent innovation in direct marketing can be seen with the company: Spotrunner.com which offers stock 30 second "infomercials" that can easily be tailored to a small company and to a small regional area. So far, they are focusing upon travel, pet care and a few other very local businesses. This has been enabled by the ability to purchase cable airings that are as local as a specific town. Advertisers get the benefit of highly professional video editing and photography without the cost and bother.

When designing a profitable campaign, the secret isn't necessarily to maximize the effectiveness of any one component, but rather to maximize the overall profit. For example, one could probably get many more people to call by promising something fantastic for free (like a vacation). Unfortunately, it's not only the cost of the vacation, but it's the cost of all of the telephone responses dealing with what might be unqualified customers that may kill the campaign's profitability. Alternatively, one could use excessively strong sales tactics to "force" customers to buy and increase the closing ratio. Again, the real cost to the overall campaign might be higher returns which eat into profits. Thus, finding the balance between the lead generation method, sales method, and the product, is essential to maximizing the overall campaign profitability.

3.12.2 Lead Generation

Lead generation is usually accomplished by the broadcast of a message. The process of broadcasting and the message that is sent have three important components; the quality of the targeted broadcast list, the informational content of the message, and the compelling nature of the call to action.

The most important aspect of the efficiency of lead generation begins with the quality of the list of eligible targeted customers. Since, the delivery of a message to an uninterested party costs the same as the delivery to an interested one, the cost of the overall campaign can be greatly affected by limiting it to only those who are eligible to buy. For example, one would attempt to deliver messages for feminine products only to women, luxury cars to the wealthy, and denture cream to the toothless. You can imagine carving up the population in a myriad of ways that best defines the likelihood of success for any particular product.

When one considers different forms of lead generation, they have different attributes in their ability to selectively deliver the message to a potential customer. For example, television long-form (which is 30 minutes in length) is most typically shown to those who watch late night television, or have cable, while television short-form (which are typically 30 seconds to two minutes in length) can be interspersed between re-runs of Lassie during daytime viewing hours and thus have the potential of a broader audience.

Direct print advertising that might, for example, appear in a magazine can be focused upon populations of readers that are more likely to be interested in a particular product. For example, a new fishing rod might do well in the publication “Field and Stream.” Conventional advertising has this same basic goal however the effect of its success is less measurable than in direct marketing.

One might consider that broadcasted messages need be constant overall customer demographics however just the opposite is true. It is desirable to tailor the message to the specific wants and needs of each demographic that can easily be identified and segregated with respect to the broadcast. For example, in television advertising, it might be desirable to have separate messages for northern and southern markets.

Frequently, this is most often demonstrated as the difference between the short form and long form infomercials for a specific product, since the viewers tend to be representative of different buying groups on the basis of age and job according to the form that they tend to watch.

In non-television forms of media, often it is simpler to tailor the message for several different groups.

3.12.3 Testimonial Endorsement

Direct marketers have generally found that it is true that the use of testimonial endorsements from satisfied customers is very effective. The use of celebrity endorsement has been shown, in fact, to be significantly better still. This has become a staple of advertising where everything from celebrity voice dubs to direct endorsement is used to push potential customers to contact the company. Christie Brinkley and Chuck Norris are thought to have each made over $30,000,000 in royalty fees on the "Total Gym" which is sold primarily through long form television infomercials.

An example of the effectiveness of adding celebrity endorsement can be seen in the Erox case study when they edited and presented their second version infomercial.

3.12.4 Television - Long form and short form

The most commonly recognized form of lead generation for direct marketing is the long-form (28 minutes in length) television infomercial. In 2005, Americans spent more than $8.5 billion[22] on products sold through this media choice. For example, the Tae Bo video sold over $600 million during its first eighteen months of airing. "People do respond to the hard sell," said Timothy R. Hawthorne, CEO of Hawthorne Direct, one of the largest producers of infomercials. As the name might imply, these ads are chock-full of information. Therefore, they are well suited to innovative products that require a relatively complicated description in order to establish the value proposition to the customer. Developing a long-form ad can cost several hundred thousand dollars for product plus the cost of talent. Star level talent will most often require a percentage of the revenue as compensation for their endorsement.

Long-form advertising has become quite formulaic. Production costs for a 30-minute ad are anywhere from $300,000 to $500,000. A short form is considerably less, typically around $50,000. Virtually all 30 minute ads are built from three 6 to 7 minute segments, each ending with a 1 to 2 minute call to action and offer. Advertisers have tried 15 minute ads with no success. Often, testimonials either from paid talent or users, sex, music, and aggressive sales techniques are most successful for pitching products. The most successful products have broad appeal and include weight loss products, self improvement,

[22] Source – New York Times April 8, 2006

exercise, and cooking. Most advertisers will admit that they believe that their products are never even used by most of their customers. High technology products tend not to do well in infomercials except for the Bose wave radio, possibly because it's not seen as a technology product. Fortunes have been made in infomercials with simple plastic products that dress your hair or cut your lawn.

However, most infomercials fail and are pulled after media testing which takes approximately one week. Infomercials that have marginal success are tuned to see if the media ratios can be put strongly in the black. Tuning involves changes in the call to action, pricing, payment terms or more extensive edits of the program material.

Successful infomercials are quickly copied unless there is patent protection however having copies in the market doesn't necessarily reduce revenues since it helps to validate the category and increase the overall category exposure.

85% of all customers respond within 10 minutes. The success of an ad in a particular time slot and station can literally be measured within several hours from airing.

Most people believe that they have never purchased anything from an infomercial. This just isn't the case. When one considers that 30 second spots that end with a telephone number to dial are short-form infomercials, it may come to mind that you actually did purchase a golden-oldies CD or a unique book through this channel. It is true, however that retail shoppers who are spending disposable income on consumer “junk” typically break into groups that have preferences for shopping. Some prefer brick and mortar retail malls others prefer the home shopping network, and still others prefer infomercials. Shopping groups tend to continue shopping in their favorite mode thus, if you've bought from a long-form infomercial before, odds are that you will buy again.

Television media time is not as expensive as one might expect. On average, 30 minute slots can be purchased for prices ranging from $50 to several thousand dollars, averaging from $600 to $1000. Television stations sell infomercial slots as a last alternative. After all, if the time slot goes unfilled, then it cannot be sold after airing. Stations strongly prefer running programmed material and selling straight advertising slots that pay significantly more per minute however with the flood of new channels, it's just not possible for them to fill every waking moment. For this reason, they all offer infomercial slots at steeply discounted prices with two caveats: the slots can be preempted if programmed material becomes available, and the slot must have a direct marketing response, i.e. a telephone number, so as to exclude typical brand advertisers. Most stations will keep a stable of known well-performing infomercial tapes “on the shelf” just in case a slot is unsold. In these cases, the station will select a tape and run it at a media cost that is calculated from the revenue generated (thus eliminating risk to the advertiser).

Note that many media types, i.e. radio, print, and television, all share this concept of having remnant markets for leftover pages or times that can be sold to direct marketers. From the marketer’s perspective, each of these campaigns yields a media ratio, so they can be directly compared for the purpose of planning a media budget. Thus, for each of these media types, there are competitive pressures across product types based purely upon the media efficiency and media ratio that adjusts the price of media in that market.

The sale of media time is a bid-ask market where competing advertisers bid through agents for particular channels and times. Each advertiser is competing with all other non-related products for time, and clearly those products that offer the best media ratios and profit will be able to pay the most for the available slots. Since broadcast television is not particularly simple to segment to parts of the population, products that have very broad appeal are generally more able to subsidize the cost of the media and thus are more typically found in television advertising.

This is one area that is undergoing change through the advent of Cable TV. It will soon become possible to literally broadcast your infomercial to unique households on more narrowly defined parameters than that the particular customer is a buyer of, for example, OXYGEN. I will discuss more about this trend later.

Short-form infomercials are still information rich however their limited length makes them more appropriate for products that do not require extended descriptions in order to establish the value proposition. In the rare cases where the value proposition is complicated, but the manufacturer still wants to use short-form because of its reach to broader television watching demographics, a two-step approach can be used. In this model, the first short-form ad attempts to convince the potential customer to ask for a DVD which contains the long form infomercial to be played on their own player.

Short form advertising’s greatest benefit is its ability to be run during daytime programming on a broader number of channels. This is especially useful if you are attempting to target segments of the population that might not be night time viewers.

Television and radio media are purchased through media brokers. Media brokers interface directly with broadcasters both at the national and regional level. Broadcasters will typically not sell directly to brand-manufacturers unless they have an established track record and substantial needs.

A media broker is typically buying for many direct marketers simultaneously. Here lies the first problem. Some media slots are simply known to perform better than others. Media buyers are caught in a bind where they would like to maximize their own income by spreading out the best slots among all of their clients thus keeping as many campaigns active as possible. As well, they are known to use the best slots with a new client for the test period so that the new campaign appears to have better media ratios than are sustainable when spread in more normal slots.

It is possible to get media brokers to buy preferentially better slots for you by statistically monitoring and managing your own media buy. One way to accomplish this is to allow the broker to over-book slots for your campaign and then for you to analyze the buy and throw out the lesser performing slots. You can improve a media ratio with this technique.

3.12.5 The Call to Action

After the selection of the list of viewers, the next most important aspect affecting the success of a direct marketing campaign is the call to action. These compelling reasons to act now include discounts, free gifts, and other special offers that are time sensitive and are intended to provoke the customer to act now. Regardless of the media type used, whether it is television, direct mail or other, the call to action is the second most important aspect of the campaign. Recall that in television direct marketing, most sales occur within 10 minutes of the air time. This said, the call to action must be effective enough to drive the customer to the next level of contact or the sale is likely to have been lost.

Many calls to action are simply discounts that can be expressed in forms including reductions in price, free shipping, two-for-the price of one, etc. Alternatively, free gifts are also often used. One often finds that luggage, a carrying case, or clothing is used as the enticements for quick action. This is true even in cases where these items bear no relationship to the product being offered. For example, a briefcase in exchange for opening a checking account. Marketers have found that the best gifts are ones where there is the greatest gap between the actual manufacturing cost and the perceived value on the part of the consumer. Because of large brand advertising budgets for clothing and luggage, in combination with the fact that these products are extraordinarily cheap to produce in China, typically it is these products that are selected for call to action gifts.

3.12.6 The Close and Telemarketing

Once a lead has successfully hooked a potential customer, often the next step involves a one-on-one telephone selling process. Alternatively, one can be directed to a website for this process or some campaigns attempt to close the sale in the first contact with a mail-in order form contained within the initial pitch.

In the current market, telephones are typically answered by operators who do not work for a particular brand company, but rather are answering calls simultaneously for a number of different products. These operators are in some cases working from their homes, and in other cases sitting in large telephone “boiler rooms.” As English language skills improve for off-shore operators, we will tend to see them used more effectively for sales as they are now used for service telephone support.

When the operator’s telephone rings, a script for the product relating to this particular call appears on the PC sitting in front of them. As they read the script, they enter the customer response that automatically moves the script through a variety of selling strategies. For example, if the customer rejects a first offer, a second offer that is sweetened might be attempted. The operator is given very little latitude other than small-talk and engaging the customer with testimonial experience. For example, an operator might add “that’s our best seller” to cajole a customer along.

The brand-manufacturer typically works with the telemarketing agency to create and modify scripts to be most effective. These scripts will be programmed into their own computer systems and there are therefore nominal setup charges. As well, conference calls or in-person training can be done for more complicated products and for motivational purposes.

Operators will be fed calls automatically by a routing switch. Measurements of the telemarketing company’s effectiveness include the percentage that close, the average selling price and the time per call. Each can be optimized for maximizing the total revenue.

The first problem is your desire to identify the best sellers and to have your calls preferentially routed to those operators. Unfortunately, you are competing with all of their other clients for the same high performance operators. It is possible for you to statistically track which operators are the best performers and to thus force the telemarketing company to comply with your preferences.

Often new clients, when testing, will have their calls routed to the best operators, thus inflating the media ratio for a test and encouraging the client to expand the program.

The second biggest problem with telemarketing companies is that they drop calls when they don't have enough operators on staff to handle a peak load. Their motivation is to have the fewest number of operators needed to handle the load, yours is to not drop any calls. Again, you must monitor the hold times and number of dropped calls independently. This again is an area where the telemarketing company can reduce the likelihood for calls being dropped for a new client that is undergoing testing.

In more contemporary systems, the caller ID can automatically give the operator information about the caller, going beyond their name and address. The CID can also be tied into a database that modifies the script on the basis of the earnings, age, and buying history of the potential customer. For example, a more affluent customer may prefer to just "buy all the options" and get off the line quickly, thus this will be the first offer – "the deluxe pack."

Telephone marketing companies have the difficult problem of load balancing. Their staffs are answering calls for advertisements that are running simultaneously all over the country for all sorts of products. Particularly popular products, specific time slots, or even the weather can cause peaks of activity that swamp their pools. In these cases, calls can be lost as they are kept on hold, or automated systems including simple prerecorded messages can be used to hold and entertain the customer.

As with most selling, the best sales records are from the best sales people. Success seems not to depend upon familiarity with the product, but rather purely on the innate selling ability of the operator.

Once a potential customer calls in to a telemarketing agency their identity and their call can actually be shared among several companies. Often after the initial product pitch, whether successful or not, the call is sold to another company which tries a completely independent pitch, and thus shares the cost of maintaining the telemarketing agency. For example, after calling in for an exercise system, you might be offered, before leaving the line, a subscription to a restaurant discount card for your neighborhood.

Recent changes in telemarketing laws that limit one's ability to call in an unsolicited fashion have caused telemarketing companies to become quite creative. Consumers forfeit their “do not call” status when they initiate telemarketing calls, and thus leave themselves open to returned calls pushing other, nonetheless unrelated products.

The consummation of the order most typically involves taking a credit card or check number from the customer. The order is then passed on to a fulfillment group which is usually in a completely different company. Bad credit cards, attempts at fraud, and crank calls typically add 10% to 20% to the telephone time costs, however very little product is ever shipped prior to confirmation of the credit worthiness of the customer. The major exception to this is when there is a time purchase with multiple payments. In these cases, a large number, often as high as 5% of the transactions, will fail on the subsequent billing attempts for a second, third, or future payment.

3.12.7 Fulfillment

Once an order is taken, a direct marketing company is restricted by consumer protection laws which require that the manufacturer ship the product within a short period of time. This is intended to keep vendors from running “dry” campaigns where they test the market without the cost or need to build any product. It also attempts to prevent the fraud of collecting funds from the customer’s credit card or bank without shipping the product.

In fact “dry” campaigns are often tried, especially in cases where the campaign is already successful in one country, and an attempt is made at another country without first preparing the product for sale. Customers that call might be told that the product is unfortunately out of stock at this moment.

Shipping and handling charges that are taken are often much more than actual shipping and handling charges incurred. In this way, many campaigns will actually recover all of their product costs purely in the shipping and handling fees and even returned product will still be profitable.

Fulfillment companies that focus purely on pick and ship processes are typically used for this part of the process. These companies will also typically handle the issuing of RMA (return material authorizations) and returned goods will be discarded, re-processed for resale or returned to the manufacturer for warranty claims. One would be surprised to find out how much is actually simply discarded because the cost of shipping and repair is often more than the original cost of goods.

3.12.8 Returns

Return of merchandise in direct marketing must be considered when appraising the entire campaign success. Unlike most retail distribution, direct marketing is a direct selling environment. Customers are being influenced with pressured presentations that sometime offer unrealistic goals – "lose 20 lbs in one week." Often, high returns can be directly related to overzealous telemarketers, unachievable claims or can simply be related to lousy products. Buyer's remorse is the most likely reason for return. If you imagine the dynamics of a person having just listened for 30 uninterrupted minutes to a high-pressure sales pitch by a professional salesperson, it's completely understandable why many succumb to the sell.

When called to return a product, the skill of the telemarketer who is handling the return call can mitigate the return, often through some concession to the customer that will tend to reduce the return value in exchange for other charge backs and telephone costs. For example, the telemarketer might offer an additional discount or free gift if the customer will keep the product.

3.12.9 Test, test and test

If we were discussing real estate, the catchphrase for success of the three most important attributes of property would be "location, location and location." In direct marketing it's: "test, test and test."

Each aspect of a campaign can be modified and potentially improved. The media ratio is a direct measurement that can be used for a simple comparison. Typically, a direct marketing campaign, for its entire life, will contain a portion of the overall budget in the neighborhood of 10% to 20% that is reserved for constantly tweaking parts of the campaign to see if the media ratios can be improved. For example, if one were running a television campaign and buying 20 different time slots and stations, it would be interesting to know which slots and station combinations seemed to be most effective. Independently it would also be useful to try several different calls to action to know which of these was most effective.

As with any good scientific analysis, it is desirable to only vary one variable at a time in order to best understand the results. However, direct marketing campaigns will often start with a matrix of combinations where territory, time and call to action are varied in ways that independently yield results on each selection.

This concept of testing can also be used when designing an overall campaign in order to save expenses incurred with poorly working models. For example, it is much cheaper to gather leads from Internet search engines than it is to gather them from banner advertising. It would be a shame to pay for expensive banner ads before one had tuned their closing message and arguments. Thus, when building a campaign, it is logical to begin with the least expensive methods for gathering leads until one has cured their message and call to action. Of course, there is interplay between the demographics of those who are initially gathered and their susceptibility to any particular pitch. But, in general it is a good idea to first tune the pitch, and then play with various lead generating techniques.

3.12.10 Repeating the Message and Reinforcement

In general, it is understood in advertising that by repeating a message, one tends to build and eventually plateau recognition with potential customers. These repeats can come over the same channel or can build by creating a campaign that uses many channels simultaneously. Often, some of the channels that are used are not conventional direct marketing channels, but rather are combinations of public relations press releases, articles, news, speaking events, etc. An effective campaign attempts to build synergy through spreading a message over many paths simultaneously.

The beauty of direct marketing is that it is equally effective as more conventional advertising for building brand recognition and product recognition. However, it has the unique attribute that it can be built as a profitable business model where marketing costs are paid for while recognition is being built. Television direct marketing media campaigns after having spent around $1,000,000 are believed to have gained fairly wide recognition and may be ready to move into retail distribution.

A common question is: how much should I spend on media and how should I divide my media budget? In some ways the answer is simple. Once various media types have been tested, one has a media ratio for each type. The higher the media ratio, the more profit. If one continues building leads in a specific channel, the channel will tend to get less efficient, thus bringing down the media ratio. Once the media ratio crosses an alternative media type, it’s time to back off a bit, and bring on the next media type.

Most campaigns are limited by the available cash flow since media campaigns, even though they have very attractive cash flows in comparison to normal retail distribution, still soak up cash like a sponge. Cash is committed to inventory, credit card hold-backs and media. Media must be paid for prior to its airing. To put this all in perspective, the Total Gym, which uses Christie Brinkley and Chuck Norris as talent, has shipped over one billion dollars of equipment so far and continues to run. There appears to be a limitless supply of customers for good products and good campaigns.

3.12.11 Mixing Direct with Retail Distribution

As stated before, it is possible for an inventor of a product to simply approach a television direct marketing company that will take on all of the aspects of the campaign and, if successful, will pay a royalty to the inventor. However, it should be noted that these direct marketing companies will also require that they share in any revenue created through conventional retail distribution.

They do this because they understand that a direct marketing campaign will build a brand and product recognition amongst consumers in the same way that conventional advertising does and that therefore, retail distribution as a method of fulfillment will also prosper from a well executed direct marketing campaign.

All too often, companies have made the error of starting their distribution strategy for a new and innovative product in the conventional retail space and then attempted to move to direct marketing. As I stated before, conventional retail distribution suffers in today's market by not having the infrastructure to sell innovative products that require description and explanation to the customer. As well, if the initial sales effort therefore fails for a new product, the response of the retailer is to simply assume that the price-point is wrong and suggest that the brand-manufacturer lower the price.

As stated before, direct marketing campaigns invest large amounts of money in the transfer of information to the consumer and thus have ratios of typically 5 to 1 of selling price to manufacturing cost. Thus, if price reductions forced on the brand-manufacturer result in a selling price below five times the cost, then it will be impossible to launch the product through direct marketing if retail distribution fails.

Figure 25 - Bowflex System

There are interesting real examples of products for which this can be studied. Bowflex manufactures an innovative gym product that uses flexing rods in place of weights. Bowflex originally attempted to sell the product through retailers who specialized in exercise equipment. Their sales failed and prices were eroding. Fortunately, they decided to pull the product from retail distribution and instead try television direct marketing. Obviously, to those of you who watch TV, Bowflex has been enormously successful over the past 10 years and only now they are re-introducing the product to retail where their high margins will be maintained because failed sales will not be blamed on the price-point. As well, customer familiarity with the product concept has been established through the direct marketing campaign so individual sales training and effort is no longer required.

In some cases, innovative consumer products that would not be intuitively obvious to the consumer viewing the product in a retail setting are best suited to direct marketing campaigns for their initial introduction. Direct contact with the customer provides immediate feedback to the company allowing it to tune the message and the product to the consumer's understanding and desires.

Different people mean different things when they refer to innovation. Retailers have been forced by margin pressures to reduce the skill level of sales assistants. Thus, as many of us have found, there really isn't much skilled help available at the retail level, especially in large box stores. Therefore, innovative products are not really well suited to retail distribution so long as the product value is not intuitively understood in the few seconds that a consumer might pass it by, read the box and continue on.

In conventional retail innovation does have a roll. However, it is limited to small incremental innovations that can be instantly absorbed by a consumer. For example, a room freshener with a 3 prong outlet is an innovative improvement that may catch the interest of a consumer.

Truly innovative products, like TiVo, are therefore not well suited to retail distribution in their early days.

One can see the troubled marketing efforts experienced by TiVo who also attempted to use retail distribution for the introduction of an exceptionally innovative product. They probably would have been better off had they started with a direct marketing campaign and then entered retail distribution later on. TiVo is actually well suited to long-form advertising. The half hour provides adequate time to explain the features and benefits of the product. The viewer is clearly a television watcher, and the initial price point can be set to cover the campaign expenses and thus pay for the advertising which establishes the brand and value proposition in the public's mind.

Ron Popeil is considered to be the grand master of long-form advertising. His "set it and forget it" catchphrase is known by all. One interesting aspect of his campaign is that when selling on TV, he cautions the customer to "not buy a cheap imitation available in retail, but be sure to get a genuine Ronco cooker." Alternatively, "cheap, imitation" cookers that are available in retail beckon the customer with "why pay more." Few know that Ronco actually is the manufacturer and importer of both products.

3.12.12 Other Media Types

Direct marketing can, and will preferentially, use a number of different channels for lead generation that all feed the same back-end telephone, web and fulfillment processes. Carrying on simultaneous media campaigns will reinforce the message and increase the media ratio of each independent channel. The investment of media dollars across media types is controlled principally on the basis of comparative media ratios.

In today's environment, within days from the introduction of a new product in television direct marketing, independent Internet marketers will lock up the keyword searches, register relevant site names and thus grab customers who use the Web to find the product that they just saw on TV. These independents will sell the leads to the primary marketer who started the campaign. Thus, more sophisticated marketers will have their web presence secured before they run their first public campaign.

Recently, Internet advertising has become quite popular. Ten or more years ago direct marketing campaigns would often start with direct mail. However, the Internet has become a superior and significantly less expensive way to test campaign concepts before committing to other, more expensive, media and production.

In addition, more consumers are becoming comfortable with guiding themselves through the closing process with a Web Browser. This is obviously significantly less expensive than live telephone support but also obviously lacks the ability to guide the user through responses based upon more subjective inputs.

Contrary to what one might expect, most commercial web presence that is selling product does not use even the most basic scripting techniques found in telemarketing. Generally speaking it is one size fits all in web selling. However, it isn't difficult to imagine the innovations that are possible and will probably be occurring over the next few years. After all, it is a computer.

The most important aspect of the variety of media that is available is that marketers must test all of the available channels in order to really understand their value to a specific product. I've seen people with 25 years of experience in the industry willingly admit that nobody knows what's going to work; the only way to find out is to test, test and test again.

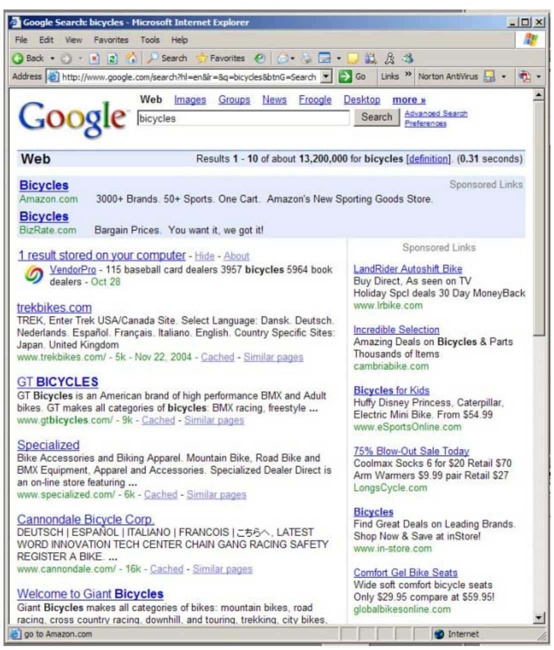
3.12.13 Internet Advertising

The Internet has blossomed to become a wonderful tool for direct marketers. With it, one can, at relatively little cost, gather leads and experiment with calls to action. In many cases it can serve as a wonderful starting point for a direct marketing campaign that eventually grows to additional media types. It is especially well suited to campaigns that are delivering web based product.

Campaigns should be designed so that they gather leads and as well gather potential customer list information that can be used with different sales models.

3.12.13.1 Search Engines

There are two strategies that use search engines like Google to bring potential customers to one's site. The first is rather straight forward and involves the commercial advertising arms of the search engines. For example, Google has an advertising entity called Ad-Words which displays in the right most column of a Google search, a list of paying advertisers. Typical placement might cost $0.10 per click through, but the price is purely determined by a bidding process for position against other advertisers who want to use the same key words. Advertisers choose their list of keywords and phrases that they want to trigger on, their bid for placement, and their maximum total cost per day. Higher bids will result in higher placement until the maximum budget is reached.



The bid price is only paid for a click-through and not for an impression (showing the ad). Click through rates are typically 1% to 5% of the impression rate. For advertisers that have exceptionally low click-through rates, Ad-words will pull the ad as not being adequately relevant to the search term.

When starting a campaign, Ad-Words can be the simplest and lowest cost method of gathering leads while attempting to tune the message and call to action. From one's initial experimentation with Ad-Words, one can create an initial media ratio and cost of customer acquisition. Ad-words gives a painless way to see which short phrases have the most appeal to potential customers who are interested in a particular category. Advertisers can run multiple versions of an ad in response to a search category and Ad-words will tabulate the relative click-through for each individual ad.

To acquire more leads, simply increase your bid for placement or increase your maximum budget per day. Or, open up your list of key words to a broader search. All will have the effect of increasing the number of hits, but as well, will probably reduce your media ratio. At some level, acquiring more leads through this engine becomes more expensive than alternative broadcast techniques and then it becomes time to move on to the next method.

Note that there will be a synergistic effect of running more than one lead generation method at a time and media ratios are somewhat interconnected.

The second method for using search engines to gather leads is to attempt to modify your own site and the sites of others so as to have Google or other search engines preferentially point to your site in the left most list of responses when a search is asked for. Typically, one can manage key words on their site for this purpose, but, the market has matured to a point where companies that purport to have unique expertise in this arena will, for a fee, modify your site and make other entries on the Internet that result in increasing the visibility of your site.

These methods, while most likely successful to some extent, carry a fixed fee that might be prohibitive for some until the message and call to action has been developed.

3.12.13.2 Email

The current level of SPAM on the Internet has made most blast email mailings relatively ineffective. However, direct marketers have found that email can still be effective if it is done in a more limited way to the subscription lists of Internet publications under their header. These email mailing lists can be rented for a fee.

Most contemporary emails send out HTML encoded emails that embed pictures along with text. These pictures are not actually transmitted but rather are accessed from a server. In this way, advertisers can tell who actually reads an email. As well, it means that emails can be subdivided into button and banner adds, much like websites.

3.12.13.3 Banner Advertising

Banner advertising or button advertising has become quite popular. Originally, the heyday of Internet stocks was partially inflated because of the predicted success of banner advertising for companies like Yahoo. However, one of the great strengths of banner advertising turned out to be its greatest enemy. One can precisely measure if banner ads are effective at bringing in business. Unlike newspaper advertisements, there is a direct and traceable connection between a user clicking on a banner ad and buying and thus, a media ratio can easily be calculated.

The value of banner advertising in comparison to all other types of advertising became immediately apparent and the news was not good for sites that were basing their revenues upon these banners. However, today, banner pricing can be reasonable and it is a naturally effective way to increase the leads being pulled to a site after the message and call to action are cured. Generally speaking, banner advertising requires a larger minimum commitment than search engines, and thus is a natural second step in developing an Internet lead generation campaign.

Banner ads can be purchased either on a click through basis or on an impression basis depending upon the vendor. For example, a price might be quoted as $50 CPM or cost per thousand impressions. If the click-through rate was 0.2%, then the click cost would be $0.10 each, similar to search advertising costs.

Fortunately, there are thousands of unique sites that appeal to specific demographics and are therefore well suited to place advertising banners for specific products. For example, an herbal cure might be well suited to webmd.com.

3.12.14 Direct Mail

Direct mail campaigns involve the mailing of a card, letter or catalog to individual consumers. In most cases the mailing list is rented for a single mailing. In some cases, the company through its own sales history will develop its own mailing list.

Direct mail suffers from the same SPAM problem that email campaigns do, albeit at a lower level. Consumers are inundated with advertising materials and thus are less likely to look at any particular piece. Unlike other media types, the delivery costs are not purely a function of the market value since the postal rates and printing rates are driven by external factors. However, the level of junk mail that is delivered should be proof enough that the model is effective in comparison to alternative techniques.

Direct mail campaigns usually begin with experiments which take a small part of the list and attempt with a few different calls to action, to determine the potential success of a campaign. After mailing, the media ratios of several different mailings, and potentially several different quality lists can be compared in order to optimize the process.

Many companies that had been printers migrated to become full service direct mail marketers. They are capable of creating artwork, messaging, buying of lists to the specific demographic description of their client and printing and mailing. Independent telemarketing and fulfillment companies would still typically be needed.

Again, it is necessary to emphasize that the quality of the mailing list followed by how compelling the call to action is, are the two most critical aspects to success in direct mail. All too often, marketers spend far too much time fretting over the graphics and messaging which is far less critical to the success of the campaign.

The concept of placing advertisements in a newspaper or magazine is not new. There has always been a symbiotic relationship between the editorial contributors and advertising contributors for publications. The editorial content drives the sale of the periodical and the turning of pages while the advertising pays the bills.

Pure advertising periodicals that are mailed are called catalogs and more recently, catalog publishers have discovered that it might help their cause of getting customers to turn the pages by inserting editorial content. We've all seen forms of this where the African explorer details his exploits on Sahara while wearing a unique cotton blend shirt.

Direct mail can effectively use "newsletter" formats and the insertion of fresh editorial content to help increase the likelihood of being read.

3.12.15 Print Advertising

Magazines and newspapers have similar problems to television media in that they are not always able to sell all of the advertising pages that they would like. As such, there is a remnant advertising market in most publications that is directed at lower prices to the direct marketing segment. Often, magazines will create special "market basket" pages that will aggregate these ads simply because they start to represent real revenue to the publication.

Like all other direct media advertising, selection of a publication and market list that closely matches your product demographics is essential to success. The pricing for direct marketing advertising pages is established through competitive bidding against others who sell to the same customers. Thus understanding the media ratio for print advertising will define if it works for a particular product.

As stated above, the potential advantage that print advertising carries over direct mail is the likelihood of getting the ad in front of a customer's eyes is increased in the magazine or newspaper format because of the editorial value of the publication.

Print direct marketing ads typically have a distinctive look of using a small font and having lots of information, very different from conventional advertising that may rely more upon graphics and simplifying the message. As well, testimonials are frequently used in print direct advertising.

3.12.16 Outbound Telemarketing

The telemarketers that are used for incoming telephone calls can also be used with scripts designed for outbound telephone. Often the call lists are simply callers who were not converted to sales during an inbound program. Recent changes in law regarding restrictions on outbound telemarketing and the creation of "do not call" lists, limits the use of outbound telemarketing in comparison to prior years.

3.12.17 Radio

Radio direct marketing is similar to television direct marketing with a few exceptions. First, radio hosts are often available as talent and can do endorsements and testimonials as part of their normal show. Media costs are generally lower than television and the demographics of listeners can be different than television watchers. Products that align well with specific vertically oriented shows can effectively use radio direct marketing.

3.12.18 Financing Media Campaigns

The statistical nature of direct marketing makes it relatively simple to finance campaigns that have strong media ratios. There are a number of bankers who understand the relative stability of direct marketing and who also understand the large portion of revenue that must be invested in media.

As such, they are often willing to underwrite media costs at relatively high interest rates with the caveat that they take a first lien on revenue collections. Keep in mind that with credit card and check payment, the cash flow for a direct marketing campaign is pretty good in comparison to most retail alternatives. If one does not use a multi-payment plan, then all of one's collections are made within days of shipment.

The only caveat is that credit card companies will withhold a portion of payments as a guarantee against returns or fraud claims by the customers. Only after a long track record of a low number of disputes will the credit card companies reduce these holdbacks. Keep in mind that any disputed charge claimed by a customer results in the immediate reclamation of the funds by the credit card company until the dispute is resolved. If, for example, you ship on a fraudulent card, you lose, not the credit card company.

3.12.19 Consumer Databases

One of the most recent innovations in direct marketing has been the collection of enormous databases which contain buying and preference information about virtually everyone in the United States. Credit card, Internet and retail information has been aggregated to literally have detailed information on each of us.

Further increasing the power of these databases, new marketers who are interested in exploiting these databases, do so under the proviso that their own information is added to the database, thus adding to its strength. For example, assume that I sell digital cameras and I perform a direct marketing test which successfully sells a few thousand cameras. Next, I take my demographic data (namely telephone data) and my sales data to a Consumer Database company. By offering it to a database firm I receive in exchange (for a fee) a stack ranking of every American in their order of likelihood to buy my product and their preferred channel for acquisition. Note that by privacy rules, the firm cannot literally divulge any information about a particular consumer, but it can sell mailing lists based upon ranking.

The power of this is enormous. In addition, the quality of the process only tends to increase as more products are entered in as real data. The resulting study can also yield tools that are critical to tuning the campaign. For example, the study will yield which features are most valued, the best price point and other related information.

3.12.20 Summary of Vendors

Running a successful direct marketing campaign might involve all of the following vendor types, in addition to those involved in the design, manufacture and import of a product:

- **Media Production Firm –** this company is artistically oriented and will have specific skills in a particular media type. For example, web design, print design, radio production and television production are all different and may require different companies.

- **Media Broker** – for some remnant media types like television, radio and print, a media broker will buy media time (space) for your ad campaign. Most media types will require independent brokers.
- **Tape Duplication** – For television and radio broadcast, it is necessary to reproduce tapes with different telephone numbers in the call to action. Separate companies produce and distribute these tapes.
- **Telemarketing** – This firm will answer the telephones and take orders. They can also be used to field customer service issues and outbound telemarketing
- **Printer** – This firm will print, fold and mail direct marketing pieces.
- **List provider** – This firm will rent you a list to a specific demographic that you define.
- **Web Hosting Provider** – This firm will host your website and maintain its presence on the Internet.
- **Fulfillment House** – This firm will pick, pack and ship your products. They may also provide simple telephone customer support and thus handle returns and RMAs.
- **Bank and Credit Card Clearing House** – this company will execute the credit card charges and credit your bank account.
- **Media lending agency** – this company will lend you money to afford the purchase of media for a known successful campaign.

3.12.21 The future of Direct Marketing

We can all see that technology is changing the methods for media delivery. Within the recent past higher bandwidth ports are opening to our homes through satellite, cable and telephone connections. The extraordinary bandwidth is greater than the available program material and thus on-demand and Internet based delivery is being added.

In Korea there are literally hundreds of simultaneous infomercials constantly playing and consumers can browse from station to station at will. However, combination of on-demand and infomercials may be the next innovation which will model the active browsing that someone might do in a brick and mortar environment.

The Internet in combination with the Google search engine already provides consumers who are a bit more technically savvy the ability to find products and comparatively shop on line. It isn't a great leap of faith to extend this model to less sophisticated shoppers through the innovation of more human interfaces.

3.12.21.1 Voice synthesis and recognition

Already, companies like Amtrak are using completely automated voice detection and synthesis systems to interact with ticket buyers. These systems are highly sophisticated and provide a thoroughly enjoyable shopping experience. The combination of voice driven systems with on-demand video presentation will create automated home shopping experiences that are far more satisfying and reach a much larger segment of the population.

3.12.22 Personal buying statistics

Combine with this, the ability to store and monitor personal shopping preferences and history and the pitch can be tuned down to the individual shopper. Thus, the need to broadcast messages that are more general to larger demographic segments is replaced with an ad directed to you, reminding you to get your car inspected and suggesting that it might be time to think about a replacement.

3.12.23 Broadcast to one

In the current direct marketing model, we have two segments, a broadcasted message whose goal is to bring the potential customer to an interactive session and the telemarketing process that adapts the sell to the individual. Clearly, the marketer would like to customize the message earlier in the process. The ability to create synthetic speech and video can move the adaptability of the pitch earlier in the sales cycle and result in the elimination of the need to broadcast at all.

Pod-casting may be the vehicle by which this first occurs. Pod-casts are broadcasts which are selected by the receiver and delivered over the Internet. They can be either audio or audio and video. By nature of the selection, the receiver is indicating a desire to receive certain types of information which can be relevant to advertisers. The advertising models that may be used might include: product placement, celebrity endorsements or conventional advertising messages or messages that are overlaid with the media like banner ads that don't affect the principal data stream. In any event, like conventional Internet advertising the receiver will have the ability to instantly switch context momentarily to indicate interest in particular offer.

3.12.24 The shopping experience

Many brick and mortar retailers today are trying to create a community of shoppers and a retail experience that brings the shopper back. Often technology is being tapped for methods to identify a customer to the store so that a personal touch can be added. This is sort of a desire to return to the days of Main Street and the personal shopping experience.

For example, retailers are offering frequent shopper membership cards as ways of building loyalty and tracking the habits of each customer. Retailers would like to achieve a level of proficiency where they can literally address you by name when you enter the store, regardless of whether they actually remembered your name or were prompted by an RFID or facial recognition system.

With technology and the ability of computers to create synthetic voice and images that are indistinguishable from real people when viewed over a television, it becomes possible to provide a personal shopping experience that far exceeds what can be done at the brick and mortar level. If consumers who even understand the synthetic nature of the salesperson can suspend reality for a moment as they do in the movies, then they can be led through a customized buying experience that is precisely tailored to their needs, preferences and history.

And, these synthetic sales people can become more engaging by mixing editorial comments in along with the pitch. For example, maybe the news, weather or a stream of new jokes and a song will accompany the pitch purely for its entertainment value. Hey, it might be fun? When's the last time you had a salesperson sing to you?

3.12.25 Consumer Multi-Tier Marketing or Direct Selling

For the last 40 years, since the advent of Tupperware many companies have found success with multi-tiered marketing. These include companies like Mary Kay, Herbalife, Avon, Longaberger, Pampered Chef, Body Shop at Home, Amway, and more recently, Creative Memories and Partylite.

Originally, the success of Tupperware may have relied upon the post World War II forcing of women out of the factory workforce back home in combination with America's fascination with technology. Earl Tupper and his partner Brownie Wise showed women how they could defy the limitations they faced and start up their own businesses from their kitchens. WGBH has an excellent historical review of Tupperware as part of their American Experience series.

Currently, Direct Selling in the United States has climbed to become a $29.7B channel[23] and a $99.4B industry world-wide. This channel uses people who are otherwise employed or engaged in homemaking and provides them with an alternative source for income with flexibility

[23] Source – Direct Selling Association and Partylite Inc.

in schedule. Products range from cosmetics and wellness products to home décor and clothing. The largest categories include:

- $9.2B of Personal Care Products
- $9.1B of Home/Family Care Products
- $4.8B of Wellness Products
- Other products including toys, children's accessories, photos, etc.

There are two popular sales models: one-on-one selling and party sales. Sellers, who represent the channel, are motivated by any and all of the following values:

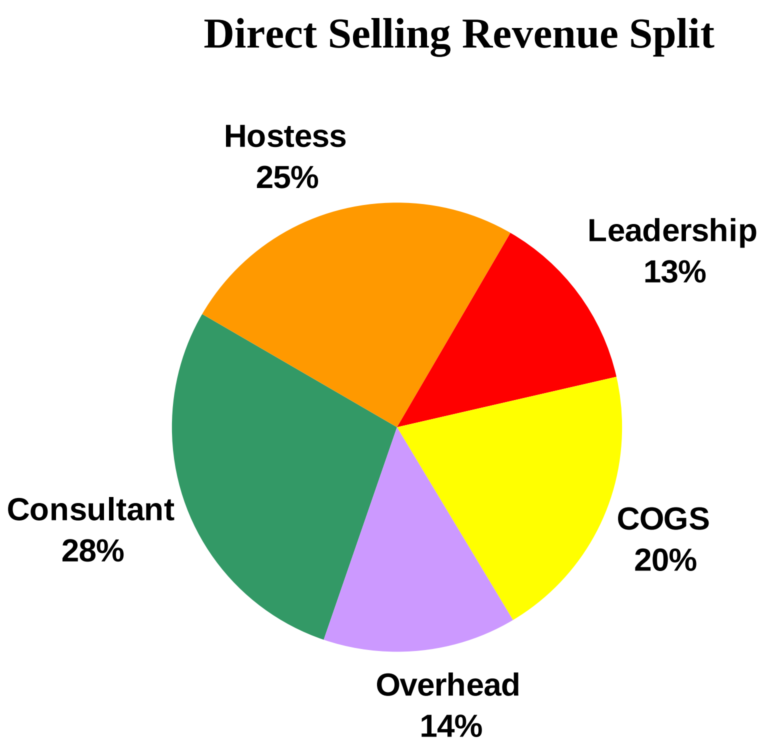
- The ability to buy product at Wholesale or Discount prices
- Short-term financial goals
- Long term financial goal through Part-time employment
- To build a Career in direct selling
- To develop and expand Social Contacts – a girl's night out
- Recognition
- Sharing the benefits with others

Today, there are 13.6M direct sellers in the United States and over 54M globally. In the US, 80% of these resellers are women, mostly married with three or more people living in their household and approximately half having bachelor's degrees or higher.

Sales people involved in direct selling often move from company and product line to company, bringing their connections with them resulting in relatively high annual turnover.

Each sales person or "consultant" attempts to personally sell the product to a group or an individual that is similarly minded, often in their home, or in the home of the customer or hostess. Customers are encouraged not only to purchase product for their own use, but to come on board as resellers, working under the sales person who recruited them. Party sales generally have a hostess who allows the customers to join in her home. The sales person and hostess are rewarded for sales. Each sales person is rewarded for their own sales, and for the sales of those under them. The development of a large successful pyramid (shown in the chart as "Leadership" of sales people under you can actually make you quite a bit of money.

Revenue for a typical party based company might be split as shown below where the overhead includes distribution costs, promotions, operating expenses and profit contribution. Note that 66% is allocated



to selling costs.

In addition to the direct revenue compensation, direct selling organizations typically make a big deal recognizing individual achievement. For example, Partylite will send 3,000 of its consultants to Aruba in May 2006 at a cost of $15M to $20M. Often this is the best and only time that many of these sales people will experience high-end travel and hotels.

Often, the products are not particularly innovative but might be of generally higher quality. Nor are product catalogs complicated since there is a focused effort on selling a few items in a single meeting. For example, AMWAY for years was simply selling soap. It was the personal touch and the story that made the product desirable. Markups are in the range of five to seven times the manufacturing cost where most of the margin is spread over the sales organization.

Individual consultants can earn compensation ranging from an average of around $20,000 per year to hundreds of thousand dollars (Partylite reported that its highest earner, a Senior Regional Vice President, earned $682,999 in 2005).

In some cases, resellers are forced to buy inventory to stock as part of signing up. Companies that are members of the Direct Selling Association agree to operate according to a code of ethics that requires that unsold inventory be taken back by the company; however, less scrupulous companies might "stick" their sales force with the excess product.

On a positive note, as stated by Frank Mineo, President of Partylite's direct selling group: "While the economic contributions of jobs, personal income, investment and taxes can be quantified, the social contribution made to individual families' lives and well-being is immeasurable. Increased self-esteem, self-confidence, organization and management skills are just a few of the transferable skills independent sellers learn. In addition to the supplemental income source provided by direct selling, these factors play a major role in building a stronger future for independent sellers, their families, their communities and their country."

Often, an important part of the sales pitch is the feeling of communal belonging on the part of the sales people. For example, Creative Memories sells scrap-booking tools and is virtually all female with a majority being successful in other full time jobs. Their involvement with Creative Memories satisfies not only a supplemental revenue opportunity but also provides a forum for creating a network of like minded friends.

Multi-tier programs have the opportunity to be used for innovative new category products where a high level of informational content is required to sell the product, as in infomercials. However, I have not yet seen this happen. I would suspect that we will see new communities be recruited into new multi-tier programs in the future. For example, students, young married, etc.

3.12.26 B2B Direct Marketing

Most B2B selling is of the form described by direct marketing. For most businesses, the media selections don't include radio or television advertising simply because of the inefficiency of these media types with respect to the targeted audience.

Most frequently, lead generation for B2B sales are accomplished through:

- Outbound telemarketing
- Direct mail
- Magazine advertising in trade journals
- Public relations efforts resulting in print media including
    - New product announcements

- Applications articles

Media ratios and costs per lead are calculated identically as one would do so in B2C examples. As well, effective calls-to-action through the use of free gifts, special pricing or other incentives is as important as in consumer based businesses.

The cost and complexity of the follow-up sales process is often dictated by the sales value and the complexity of the value proposition. In some cases, in-bound telemarketing centers can complete the sale while in other cases one or more in-person sales visits might be necessary.

The sales process, as in the B2C case, will usually involve a series of “steps” that can be tracked and modified as described in the section on Selling. The total cost of selling along with the media costs for collecting leads must be compared to the revenue in order to see if particular campaigns are profitable or need to be tuned.

It is my experience that unlike B2C direct marketing, there is considerable sloppiness in developing the statistical models, and measurements in most B2B sales processes so as to effectively increase profitability by improving the lead generation and sales process. It can be especially useful to apply those techniques found in B2C direct marketing to B2B businesses in order to optimize profitability. As well, the redundancy, use of testimonials and careful description of the value as found in infomercials can serve as a good model for in-person selling of business products. Just try to keep from saying “but wait, there’s more.”

3.13 Campaign Management

My experience of having run a consumer products company that did direct marketing gave me a new perspective on marketing in general that is based upon the use of metrics. Direct marketing is all about metrics. Eighty percent of the sales generated from a specific direct marketing ad typically occur within only twenty minutes after exposure to the media. As a result, direct marketing campaigns rely heavily upon measuring the specific profitability of each individual media event down to, as in the case of television, the individual time and channel slot.

Historically, when we observe the advertising that has been done by large companies in what are typically retail business models, it has been hard to create similar discrete metrics that demonstrate the value of any one campaign. The Internet and the introduction of segmentation through cable television have impacted advertising and campaign construction in an essential way: all advertising is seeking methods to rationalize its use by creating metrics that are clear and unassailable to the advertising customer.

Typically, student business ideas have a variety of choices for channel selection and marketing method. One of the keys to success is to create an objective method for selecting the best way to market and sell a product.

For example, I had a student team, led by Rahul Sahni that developed “foldable shoes” for women. The concept was simple: women whose feet hurt after a long day at the office, or a long evening of partying, in high heels would like the idea of having a spare pair of foldable comfortable shoes in their purse. Today, their website can be found at http://www.fitinclouds.com.

The idea seemed to have merit and many of the other students expressed interest in the product. In fact, the team observed that there were at least six other companies that they could find online that were already selling similar shoes.

It appeared that none of the competitors had found real success in their marketing programs which varied from Internet sales to vending machines. So there seemed to be the potential for establishing a new business based upon this product introduced through a more effective marketing strategy.

To digress for a moment, it is interesting to note that simply the existence of others in the market should not be enough to dissuade you from entering it, especially if they have not appeared to have created an effective way to market their products thus far.

The student team developed several alternative methods for marketing the product which included:

- Sell through bars and nightclubs by the bartenders
- Sell through bars and nightclubs by the coat check person
- Sell through retail establishments like seven-eleven stores
- Sell through shoe stores
- Sell through the Internet
- Sell through an OEM relationship with a high end women's shoe brand
- Sell through direct marketing on media like TV or radio
- Sell through kiosks in malls
- Sell though word of mouth from happy customers
- Sell through kiosks located outside clubs in the evening

Clearly, there were plenty of alternatives. The problem that I would like to address in this chapter is only: how to choose?

My proposition is that if there is a straightforward metric method for the comparison between these alternatives, then one can pick the best based upon that metric.

If we consider that each of these is simply a different method for "buying customers" then the simplest metric would be the lowest cost per customer. But, this isn't always easy to calculate, especially if the founders, who typically do not charge for their time, are involved in some or all of the methods.

3.13.1 The Campaign Profit and Loss (P&L)

Typically one learns in business school to create a pro-forma P&L which, in a highly simplified form, looks, for any specific period of time, like the following:

+Revenue
<u>- COGS____</u>
=Gross Margin
- Marketing & Sales
- Administrative Expenses
<u>- R&D Expenses__</u>
=Net Profit

Figure 26 - The typical P&L Statement

It is important to note that for the most part, these line items can be divided into those that are fixed and those that vary with revenue. For example, R&D expenses and Administrative expenses are fixed to a particular budget while marketing and sales costs as well as COGS vary with revenue.

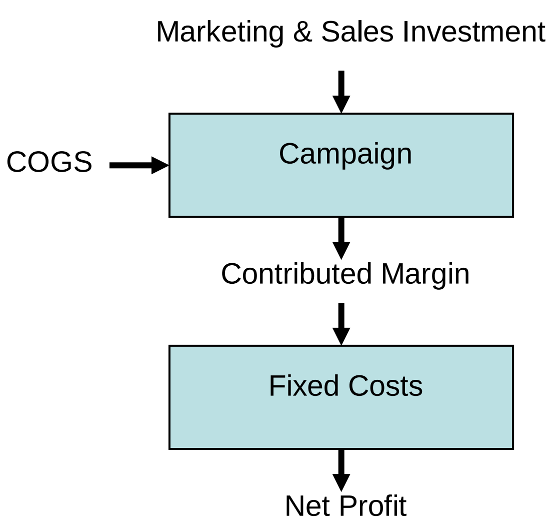


Figure 27 - Variable Cost Model

One must begin by assuming that once an effective marketing plan has been developed then the marketing and selling expenses should really be considered as an investment in future revenue. Especially for small campaigns, varying the marketing investment will linearly affect the selling and COGS costs as well as eventually recognized revenue. Often, cash flow constraints limit the ability of a small company to maximize its revenue by limiting the amount of cash that can be invested in marketing and thus future revenue.

The delay of receiving revenue from the marketing investment often clouds the financial analysis of a marketing campaign. As well, a company can run many campaigns simultaneously, even some for the same product. For these reasons, it is useful to create an independent method for planning and tracking each campaign. The Pro-forma Campaign P&L should only contain the variable revenue and expenses associated with a particular media and advertising selection. Production costs, for example the development of a television infomercial should not be amortized or included at all within the pro-forma Campaign P&L. These costs should appear within the corporate P&L.

Returning to my student's "foldable shoes" problem, the best method for determining which the many alternative strategies is best is to create experiments where one measures the actual cost and relative success of each strategy. For the moment, let's not consider which strategy might be most successful based upon consideration of whether this is a new or preexisting category.

This implies several important things:

First, you must actually try the process; there is nothing like real data.

Second, you must create what are called "standard costs" for the various components and understand their actual costs when you attempt to scale them up.

For example, let's examine two specific cases.

For the first case, let's assume that they attempted to place a kiosk at the exit to nightclubs.

What would the cost of each "kiosk event" be? A kiosk event would include the direct labor of the sales person, the amortization of the kiosk hardware, the transportation cost of moving the sales person and kiosk to the event and back and whatever other giveaways or incentives that were used and lost as part of selling.

In addition, the variable costs of a "kiosk event" would include the cost of manufacturing the product and shipping it to its storage place, and any transaction fees like credit card fees and even the gift bag delivered to the client.

When the first experiments are done, the actual sales people are the founders, but, counting their "hoped for" salary when calculating the cost of the event would not be fair. Instead we would use the expected salary level of a person hired to do that job, in this case, possibly a college student who might expect $15 per hour.

If we were to actually attempt to sell foldable shoes at a few such events, we would collect real data that would help us to build a model that included the real transportation costs, the real number of hours worked, and most importantly, the number of shoes sold.

Combined, these can help us to build a variable cost model for selling through this method. But, we are not done yet. If we attempt to scale this model, there are various effects that we need to consider. On the positive side, the cost per kiosk can go down since we can get kiosks built in Asia, but on the negative side, we must recruit and manage potentially hundreds of sales people. Somehow we need to consider both the cost and practicality (or scalability) of this model.

In this case, the kiosks are really little retail operations and retailers also need to consider what is called "shrinkage" or theft, license fees, maintenance, employee benefits, etc. This model, which at first might have appeared to be attractive possibly isn't looking so good anymore?

For the second case example, we can elect to evaluate a retail distribution model, where we attempt to sell the shoes through seven-eleven stores. In this case, the store will expect a discount (their margin). Again, we have some transportation costs to the store.

When this model is scaled, we realize that we do need sales representatives and distributors who will assist us with the sales processes to stores and with the management of the inventory.

As well, the retailer may expect what are called "marketing supports" (which are defined as advertising fees paid to the retailer by the vendor), and allotments for returned defective products.

There is another important problem that is encountered when attempting to understand how a business model will scale: how to determine the manufacturing cost when you don't know the volume?

Experienced business people who have been in a market for some time will develop an intuitive sense about manufacturing costs but students are confounded by the problem of properly costing a product so that they can figure out the best distribution model.

For example, in the case of Rahul's shoes, if one attempted to sell through television direct marketing, an assumption about the manufacturing cost which varied from one dollar to three dollars could force a variation of selling price from $9.99 to $14.99 which might have dramatically different results. In fact, regardless of the distribution model, for this type of consumer product the selling price has the ability to dramatically affect the cost of customer acquisition.

There are two rules to follow. First, the testing of prices should be somewhat independent from the perceived real manufacturing cost within some rational boundaries. (There is no point testing prices that are not achievable.) But, more importantly, it is necessary to obtain costing information at wildly different volumes in order to understand what latitude one has when scaling different models. In Rahul's case that implies that he must get quotations at quantities ranging from several thousand shoes per order to several hundred thousand shoes per order with annual volumes going to the millions.

It is interesting to note that when Rahul started my class his example of a successful product that he considered similar to his was the "Snuggie" a blanket with holes that sold originally through television direct marketing (and is now available in retail). It is simply a blanket with holes (or sleeves, so that you can hold a book while lying under the blanket). This product sold 4 million units in the first year.

Rahul was uncomfortable with the concept of asking vendors in Asia to quote one million units for a product for which he had, at this time, only sold a few thousand units.

Often, a single manufacturer who does not yet know you as a customer would be reluctant to give you pricing at wildly different volumes because he might believe that you're simply gaming him. Therefore it's necessary to begin the process of obtaining quotations at your highest volume expectations (or most aggressive pricing) and work down from there as you move forward with your campaign.

A sample pro-forma Campaign P & L was shown in the Direct Marketing chapter and applies to a direct marketing campaign. For direct campaigns it is important to include allowances for credit card fees, returns, bad credit cards and the labor, telephone, and travel costs associated with selling. When building a retail campaign one should be sure to include the rep costs, distributor costs, shipping, insurance, return allowances and both the advertising supports paid to the retailer as well as advertising done directly by the manufacturer to build brand and product awareness.

It is important to include a labor cost for the founders if they are fulfilling roles in the campaign. For example, if they are doing telephone marketing or selling, one must include a salary cost that is consistent with an employee that might be hired for that function. Otherwise the Campaign analysis will not be a faithful representation of the real costs involved in the campaign. If one includes real labor costs, then one can more likely scale the campaign by simply buying more media and hiring or outsourcing the other marketing and selling functions as required.

3.13.2 Revenue Assumptions

When creating the Transaction P&L there are several assumptions that can be made for creating the Revenue line.

For most consumer based direct marketing, the revenue is assumed to be the cash received on the first transaction. For example, if one is advertising shoes at $9.99 plus shipping and handling, but when a potential customer calls, they are on average up-sold to an average transaction value of $14.99 (because they purchased two pairs, the second at a discount), then the Transaction P&L would use an average revenue value of $14.99.

One can also choose to add the shipping and handling cash received to the revenue and then add a cost line item to the transaction for actual shipping and handling costs.

One of the reasons that I like direct marketing is that when a campaign is started, by, for example, running a TV ad, all of the transactions that will occur actually happen within twenty minutes of airing. This makes the process of determining whether you have a profitable transaction quite transparent.

Alternatively, many campaigns seek to convince customers not to make a single purchase, but rather to make ongoing purchases of the same, or related products.

In these cases, the assumption of what the revenue number should be for the Transaction P&L is more complicated. One assumption might be to use the total revenue received from a customer over their lifetime. After all, it is fair to consider the marketing cost to be amortized over the total revenue obtained from a customer. The only problem that this represents, and especially for the small company, is the impact that this has on cash flow. Marketing costs are incurred in the beginning of the process and if, for example, it takes a year of customer transactions to pay back the marketing costs, then your business is limited by the amount of cash that you can afford to invest in marketing.

As well, the risk is magnified by the potential that you have miscalculated the true lifetime value of the customer. This is especially true in cases where the actions of competitors can change this lifetime value. This is the primary reason that it is essential that one test smaller versions of campaigns before making large media investments.

For example, testing the first few months of continued sales to customers that were assumed to stay with the company and repurchase can build to demonstrate a self funding campaign over time.

4 Conclusion

In over 36 years of running my own businesses I have seen much of the world, met extraordinarily interesting people, ate in the finest restaurants, slept in the finest hotels and formed lifelong friendships that I continue to value each day. My journey was (and continues to be) fun, interesting and gave me a perspective on life that I have attempted to share with you through this book.

For many of you the first step will be the hardest. Fear of risk, and the unknown, causes many aspiring entrepreneurs to never make the step or delay it needlessly. If you believe that it is a life that you would enjoy, then let me encourage you to start. In reality, you risk nothing. If you are successful, then your success will more than amply repay you, if you are frustrated then at least you can say that you tried and I'm certain that getting a job will be easier for you because of your demonstrated courage.

I am reminded of the ending of the movie "The Wizard of Oz" when the wizard (exposed as somewhat of a fraud) gives out the three searched for items: a heart, a diploma and a badge of courage and demonstrates in doing so that they had been inside the recipients all along. The movie is about finding your own way and believing that you have the power to do so. Even Dorothy was already wearing the magic shoes. It's time to start and leave Kansas.

My final words:

- Starting your own business is hard work and yet extremely rewarding.
- Decide for yourself why you want to run your own business.
- Engage with customers on the first day and make it a continuing part of your process.
- Anticipate and embrace your own Drunkard's Walk.
- Watch your cash flow and stay focused on survival and the seeking out of new opportunities.
- Understand that marketing is the key problem for your business.
- Trust the metrics for marketing.
- Trust your instincts for everything else.
- Never stop learning.
- Measure your success in terms that are meaningful to you and not others.

- Have fun. Don't forget to enjoy the process.
- Call if you need help…

5 Attachments

5.1 Sample Nondisclosure Agreement (NDA)

_______________., with offices located at ____________, ________, ________________, for itself and its affiliated companies (collectively "Inventor") and _________________ of _________________________, for himself and his affiliated companies ("_________") (collectively “Recipient”), in consideration of the mutual covenants of this Agreement, hereby agree as follows:

1. In connection with ongoing discussions between Inventor and Recipient concerning possible transactions between them, or the performance of services by Recipient on behalf of Inventor, (collectively the "Transactions"), Inventor may disclose certain proprietary and confidential information to Recipient on a confidential basis. Such proprietary or confidential information ("Information") includes any and all technical and non-technical information, including without limitation, information concerning financial, accounting or marketing reports, business plans, analyses, forecasts, predictions, projections, intellectual property, trade secrets and know-how disclosed in connection with the Transactions. "Information" may take the form of documentation, drawings, specifications, software, technical or engineering data, and other forms, and may be communicated orally, in writing, by electronic or magnetic media, by visual observation and by other means. "Information" includes any reports, analysis, studies or other materials, whether prepared by the receiving party or otherwise, that contain or are based upon proprietary or confidential information covered by this Agreement. Furthermore, Recipient agrees and acknowledges that any and all work product developed or produced in connection with the Transactions shall be the exclusive property of Inventor and Recipient shall have no ownership interest therein.

2. "Representatives" means the controlled affiliates of either party, and the respective directors, officers, employees, attorneys, consultants and other agents and advisors of either party or of the controlled affiliates of either party. Each party shall be responsible for any breach of this Agreement by its respective Representatives and shall take all reasonably necessary measures to restrain its Representatives from unauthorized disclosure or use of Information.

3. All Information which is disclosed by Inventor to Recipient in connection with discussions relating to the Transactions, whether before or after the date of execution of this Agreement, shall automatically be deemed proprietary or confidential and subject to this Agreement unless otherwise confirmed in writing by Inventor. In addition, the existence and terms of this Agreement, and the fact and substance of Inventor's discussions and correspondence with Company relating to the Transactions, including the identification of either party by name or identifiable description in connection with the parties' participating in such process, shall be deemed Information of both parties and shall not be disclosed by either party without the consent of the other party.

4. With respect to Information disclosed under this Agreement, Recipient and his Representatives shall:

a. Hold the Information in confidence, exercising a degree of care not less than the care used by Recipient to protect his own proprietary or confidential information that he does not wish to disclose, and in no event less than a reasonable degree of care;

b. Restrict disclosure of the Information solely to those Representatives with a need to know and not disclose it to any other person;

c. Advise those Representatives of their obligations with respect to the Information; and

d. Use the Information only in connection with continuing discussions by the parties concerning the Transactions, except as may otherwise be mutually agreed upon in writing, and shall reproduce such Information only to the extent necessary for such purpose.

5. Information shall be deemed the property of Inventor and, within ten (10) business days upon written request from the disclosing party, the other party will return all such Information received in tangible form to the disclosing party or will destroy all such Information.

6. Recipient shall have no obligation to preserve the proprietary or confidential nature of any Information which:

a. Was previously known to it free of any obligation to keep it confidential; or

b. Is or becomes publicly available by means other than unauthorized disclosure; or

c. Is developed by or on behalf of Recipient independent of any Information furnished under this Agreement; or

d. Is received from a third party whose disclosure does not violate any confidentiality obligation.

7. Neither this Agreement, nor the disclosure of Information under this Agreement, nor the ongoing discussions and correspondence by the parties concerning the Transactions or any other matter, shall constitute or imply any promise or intention to make any purchase or use of products, facilities or services by either party or its affiliated companies or any commitment by either party or its affiliated companies with respect to any other present or future transactions. If, in the future, the parties elect to enter into binding commitments relating to the Transactions or any other transaction, such commitments will be explicitly stated in a separate written agreement executed by both parties, and the parties hereby affirm that they do not intend their discussions, correspondence, and other activities to be construed as forming a contract relating to the Transactions or any other transaction without execution of such separate written agreement.

8. Inventor retains the right, in its sole discretion, to determine whether to disclose Information to the other party, and disclosure of Information of any nature shall not obligate Inventor to disclose any further Information.

9.Recipient (a) acknowledges that Inventor makes no representation or warranty (express or implied) as to the accuracy or completeness of any Information, and (b) agrees to assume full responsibility for any and all conclusions it may derive from the Information. Inventor hereby expressly disclaims any and all liability that may be based in whole or in part on any Information, errors therein or omissions there from.

10. In the event that Recipient or his employees or Representatives (a) need (for securities law purposes) to make disclosures of Information or (b) are required by law, regulation, or government agency or court orders, interrogations, requests for information or documents, subpoenas, or civil investigative demands to disclose any Information, in the case of (a) Recipient shall provide Inventor with prompt written notice so that Inventor can work with Recipient to limit the disclosure to the greatest extent possible consistent with legal obligations (it being understood that disclosure of the name of the other party will never by made without that party's prior written consent); or in the case of (b), Recipient shall use his reasonable efforts to minimize such disclosure and obtain an assurance that the recipient shall accord confidential treatment to the Information, and shall notify Inventor contemporaneously of such disclosure.

11. Nothing contained in this Agreement shall be construed as granting or conferring any rights by license or otherwise in any Information disclosed, or under any trademark, patent, copyright, mask work or any other intellectual property right of either party. None of the Information which may be disclosed or exchanged by the parties shall constitute any representation, warranty, assurance, guarantee or inducement by either party to the other of any kind, and, in particular, with respect to the non-infringement of trademarks, patents, copyrights, mask works or any other intellectual property right.

12. This Agreement shall benefit and be binding upon the parties hereto and their respective successors and assigns.

13. This Agreement shall be governed by and construed in accordance with the local laws of the Commonwealth of Massachusetts without regard to conflict of laws principles.

14. This Agreement shall become effective as of the date on which it is first executed below ("Effective Date"), provided that this Agreement shall cover all Information disclosed by Inventor to Recipient (whether before or after the Effective Date. Disclosure of Information under this Agreement may take place for a period (the "Information Disclosure Period") of two years after the Effective Date. The obligation of the parties contained in Paragraphs 5 and 10 shall survive and continue beyond the expiration of the Information Disclosure Period by a further period of two years.

15. Recipient agrees that Inventor would be irreparably injured by a breach of this Agreement by Recipient or his Representatives and that Inventor shall be entitled to equitable relief, including injunctive relief and specific performance, in the event of any breach of the provision of this Agreement, but shall be in addition to all other remedies available at law or in equity.

16. This Agreement (a) constitutes the entire understanding between the parties with respect to Information provided in connection with the Transactions, (b) supersedes all prior agreements between the parties with respect to Information provided in connection with discussions relating to the Transactions and (c) shall bind each party with respect to all Information received by it prior to the expiration of the Information Disclosure Period. No amendment or modification of this Agreement shall be valid or binding on the parties unless made in writing and executed on behalf of each party by its duly authorized representative.

IN WITNESS WHEREOF, each party has caused this Agreement to be executed on its behalf as of the Effective Date.

Inventor

Name:___________________________ Date:_____________________

Recipient

Name:___________________________ Date:_____________________

5.2 Simple one Page Partnership Agreement[24]

This PARTNERSHIP AGREEMENT is made on ____________, 20__ between _______________ and_______________

1. **NAME AND BUSINESS**. The parties hereby form a partnership under the name of "".

2. **CAPITAL**. A capital account shall be jointly funded and maintained by both partners. The capital account shall be maintained at all times in the proportions in which the partners share in the profits and losses of the partnership.

3. **PROFIT AND LOSS**. The net profits of the partnership shall be divided between the partners in proportion to their ownership. Net losses shall be borne in proportion to ownership, as well.

4. **INTEREST**. No interest shall be paid on the initial contributions to the capital of the partnership or on any subsequent contributions of capital.

5. **MANAGEMENT DUTIES AND RESTRICTIONS**. The partners shall have equal rights in the management of the partnership business. Without the consent of the other partner neither partner shall on behalf of the partnership borrow or lend money, or make, deliver, or accept any commercial paper, or execute any mortgage, security agreement, bond, or lease, or purchase or contract to purchase, or sell or contract to sell any property for or of the partnership other than the type of property bought and sold in the regular course of its business.

6. **CONTROL**. All major decisions require consensus between both partners. Both partners have a "No Veto", meaning they can say "no" at any point and have that decision respected, with no questions asked.

7. **PARTNER EXIT**. The exiting partner, Partner A, presents a valuation for the total company and agrees to either buy or sell outstanding shares at that valuation. Partner B then decides whether to buy or sell. Buying partner will have 90 days to raise capital for the purchase. If buyer cannot raise the capital, seller has the option to buy. If neither party can complete the purchase, Partner B restarts the process with a new valuation for the total company.

8. **DEATH**. In the event of a Partner's death or severe incapacitation, his shares transfer to his estate. Remaining partner is required to purchase outstanding shares at a minimum valuation of 4x EBITDA (3yr trailing average), for the total company. The estate is required to sell at a minimum valuation of 4x EBITDA for the total company.

9. **TRANSFER OF OWNERSHIP**. The partnership may be dissolved at any time by agreement of the partners, in which event the partners shall proceed with reasonable promptness to liquidate the business of the partnership.

10. **AMENDMENTS**. This document can be amended at any time with the signature of both parties.

Executed this ______________ day of _________________, 20_____ in _____________________ [city], _____________________ [state].

[24] Courtesy of Brian Hayden and Duncan Miller of Heatspring

5.3 Starting a Limited Liability Corp. (LLC) in MA

The following is list of basic steps for creating a small business that you can operate from your home. I would suggest starting with an LLC form of business (Limited Liability Corporation). You can always change it later. Each line has a number of helpful websites

- Pick a company name and make sure that the URL (Domain Name) is available.
    - http://www.whois.net/
    - http://tess2.uspto.gov/bin/gate.exe?f=tess&state=5v3d2n.1.1
- Register the URL (Domain Name) and obtain a domain hosting site. You will need a credit card and this can be done on line. These can both be done with a single entity. Dataflame, listed below is one of many. It should cost less than $100 per year.
    - http://www.dataflame.com/
- File a DBA (doing business as) certificate with your town listing your own address. Be careful to not indicate any activity as part of your business that might be unacceptable from a zoning perspective. The specific certificate will be available at your town offices. Your town may have filing fees.
- Obtain a Federal Tax Identification number, also known as an Employer Identification Number (EIN). There is no charge and this can be done on line.
    - http://www.irs.gov/businesses/small/article/0,,id=102767,00.html
- Register your new entity with the MA Secretary of State. In MA the fee is $520 and can be paid on line with a credit card.
    - https://corp.sec.state.ma.us/corp/loginsystem/login_form.asp?FilingMethod=I
- Open a bank account. You will need to bring a copy of your DBA certificate and your EIN and $20 as an initial deposit.

5.4 Written Case Attachments

5.4.1 Liberty Medical Supply Case Information

By: Bob Caspe

In 1996 Steven Lee and his partner Arthur Siciliano created a new medical holding company, PolyMedica and one of their first acquisitions was a relatively sleepy company, Liberty Medical Supply. They bought Liberty Medical for around $11M or approximately a multiple of one times current sales. Within seven years, Liberty would grow to over three hundred million dollars in sales and have hundreds of thousands of customers.

Liberty Medical Supply was founded in 1989 in Palm City, Florida, solely to provide a reliable source of diabetic supplies to patients with Medicare or private insurance coverage. By 1996 Liberty had grown to have about 20,000 customers nationwide. As a participating Medicare supplier, Liberty Medical shipped the customer their diabetic supplies first and then billed Medicare or the Insurer. The customer then received a bill for only the amounts not paid by their insurance or Medicare (often only a small deductible amount or percentage). Liberty had approximately 70 employees, many trained specifically to work with the needs of the diabetic customer with respect to their testing supplies. The company maintained a 24 hour telephone call center to handle customer requests. It was interesting to note that at this time, there was almost a 100% turnover per year in the call center.

Liberty would inventory several hundred individual products, all manufactured by other companies. By 1996, their marketing campaigns included direct mail, and, for the most part, print advertisements in Penny Savers which generally print local advertising and coupons and are distributed either by mail or for pickup at retail locations. At that time, the company was adding roughly 300 new customers per month.

Steve and his partner felt that the principle barrier to marketing success for Liberty was that the value proposition was simply too hard to explain through print and penny saver advertising. They felt that a media that was richer in information content would be better suited for their advertising. They elected to use a relatively new media type, the short form 30 second television infomercial.

In 1996 they created their first in a series of infomercials, the original “Marjorie” ad, at a cost to produce of $75,000. In their first weekend of running, they generated 3,000 new customers. They were caught somewhat unprepared for the success they enjoyed. Customer acquisition costs would be in the range of $50 and the average customer would spend $1,200 per year at a gross margin of 50%. It was clearly a profitable business model.

Steve is a stickler for details and came to quickly understand that one key to the business would be a fanaticism towards accuracy since he was dealing both with medical supplies, the US government and a myriad of state government regulatory agencies and filing details.

Liberty needed to expand their own call center since each new customer would result in a minimum of one inbound call and two outbound calls: one to the customer and one to the customer’s doctor. Initially, the sales processing time was over 1 week and eventually would be tuned to less than one half day.

In 1997, Steve decided to gather some firsthand marketing information by visiting real customers to better understand who they were. This was something that he instituted for his management staff for as long as he was with PolyMedica. They discovered that most of their customers were seniors, relatively poor and on Medicaid or Medicare.

As well he decided to try to use a well known talent for the infomercial in place of Marjorie. It had become understood that the endorsement of one’s product by recognized talent could improve an infomercial campaign.

Their first attempt at talent was Lauren Bacall. While Ms. Bacall required an upfront payment of $100,000, Steve was smart enough to negotiate the remaining payment to be conditional upon his agreeing to run her ads. After reviewing the final tapes along with a TV trial run, Steve decided that his customer base simply wouldn’t identify with Ms. Bacall.

As a result, he then decided to shift the campaign to a respected older television actor, Wilfred Brimley who is a diabetic and whose style and name he felt would be more readily accepted among the principle clients of Liberty.

The new ad began to draw 15,000 new customers per month and resulted eventually in the need for computer systems to handle over 10,000,000 inbound and 10,000,000 outbound telephone calls per year.

Clearly, the enormous traffic generated required the innovation of completely new IT systems, an integrated warehouse facility, quality assurance systems and call center technology, all of which were developed within Liberty. They even went so far as to negotiate a new class of postage with the US Postal Service that required a signature confirmation for delivery at a more attractive rate than previously available. A signature confirmation was needed as part of their meeting Medicare requirements.

During the heyday of growth of Liberty, Steve created an employee ethos that emphasized enthusiasm and caring for their customers. As such, employee turnover was vastly reduced and Liberty became the third largest employer in St. Lucie County Florida. Liberty's product line continued to expand to include products targeted at the chronic care of its Medicare customers.

Revenue and profit growth for the period from 1998 to 2002 for Liberty is shown below. Liberty Medical accounted for roughly 80% of PolyMedica revenue and profit. By 1999 Fortune Magazine listed PolyMedica in its list of "100 Fastest Growing Companies" and their stock was moved from the American Stock Exchange to NASDAQ under the symbol PLMD.

	2002	2001	2000	1999	1998
Revenue (000)	207,262	166,769	125,999	80,597	48,708
Income before Taxes (000)	35,767	33,726	19,631	5,300	1,140

Steve left PolyMedica in 2002 and today pursues a variety of interests and businesses.

5.4.1.1 Case Questions

1. Watch the two exampled video infomercials. Why was the second one more successful?
2. How would you improve upon their infomercial?
3. If you wanted to try to recreate Liberty's success with your own acquisition, what attributes would you look for in a current business?

5.4.2 Pixifun Case Information

Pexagon Technologies is a small company located in Connecticut that currently focuses on the sale, under the Microtech brand name, of micro-drive digital media which is used for digital cameras and other CF compatible equipment. Pexagon originally was spun off in 2002 from SCM and maintains a relationship with Hitachi (formerly IBM micro drives) as their sole distributor. Hitachi is also releasing a new drive called “Store-it” in 20 GB and 60 GB sizes for removable backup which will also be sold under the Microtech brand. Pexagon had a few other products that they also sold which were eventually dropped because of other mergers and acquisitions.

Currently, Pexagon has 16 people, down from a maximum of 25.

In 2003, the CEO, Brian Campbell wanted to find some diverse products that could added to their product line. He would typically go twice per year to Taiwan for local trade shows to see new manufactured product.

Brian liked the Pixifun (not called that in Taiwan) product because it was different and unusual and he saw the potential of building an entire line of digital camera accessories from this new product. He envisioned a complete product line consisting of various frames and printing tools. The manufacturer in Taiwan told him that the product was already introduced in Australia and was doing well (this was not checked). There were initially five product variants: magnetic, keychain, ID, CD label, photo sticker book. Not all retailers decided to carry all of the products. However, in the end, success did not seem to vary depending upon the number of products taken.

Deals struck with different retailers were different in quantity, price and risk. As well, different retailers picked what they thought were the appropriate retail price points and when sales did not materialize the retailers quickly moved the prices down. With the exception of Target, no retailer made any effort to create demand for the product. Target, upon getting advice from marketing consultants, created a “digital camera accessory” category in their store and sourced several disparate products. The concept failed, Pexagon believes because of the placement within the store.

Pexagon believes that buyers were for the most part uninterested in the product’s success since it wouldn’t create much revenue in any event. It was believed that buyers generally accepted the product in a desire to keep a good relationship with Pexagon since the micro drive products were doing well. After a year of waiting for the product to move, buyers were beginning to focus on holiday season shelf stocking and thus were now forcing the issue of clearing or returning unsold inventory.

In total, the marketing budget so far has been around $350,000. The product packaging has been redesigned three times so far with little impact. The company has currently reduced the internal labor effort to only 30% of one employee and if sell through continues to lag, the product will be dropped by the end of this year.

The latest version of the product is the photo-charm for attachment to a cell phone. The retail price is suggested to be $4.99. The FOB cost is $0.93 and the transfer to retail at $250. While there seems to be reasonable interest with Wal-Mart and CVS, the terms offered would place all of the risk onto Pexagon and given the performance to date, the company is reluctant to take the orders. CVS is currently unwilling to try a test in a few stores. Currently, Pexagon is testing the latest product at a few franchised Cingular stores locally located. Deals were struck with the individual store owners and a “mini-Plano gram” display was done. If it is successful, then approaching corporate stores and re-visiting CVS and Wal-Mart may be in order.

The company states that if it had unlimited marketing funds, it might have tried to create product awareness through advertising in teen oriented media.

The following represents a timeline for the Pixifun product

Fall 2003

- Product first seen at trade show in Taiwan
- Discussions with manufacturer to enter into partnership
- Basic business plan done. The initial pricing was:
    - The FOB landed cost of the larger clamshell pack was $2.50. The cost to the retailer would be $8.29 with 5% for distribution, and 5% for rep cost, 8.29. The suggested retail price would be $12.99. (which gives the retailer 25 points, which is high) Note that the distributor fee was reduced for the opening orders since there was not a lot of work to do for these orders.
- Worked to design packaging using existing manufacturer clamshell design
- Sold old version at Shoppers Village (local flea market) for test

January 2004

- Exhibited at the CES Trade Show
- Eckerd’s VP of Marketing shows interest in product but was being bought out (need to wait)
- Compiled list of top 75 target accounts to go after in the photo channel and national chains
- Began contacting accounts and reps for appointments
- Attended the LA Gift Show with manufacturing partner

February 2004

- Exhibited in PMA Trade Show

- Talked with Staples, Ritz, CompUSA, Radio Shack

March 2004
- Discovered I/O Magic product- competition- exact product knock off
- I/O Magic discovered at Ritz
- Begin discussions with Lexmark for Holiday promotion
- Worked on Variety pack for Club Stores

May 2004
- Hired Marketing Support Specialist
- Compiled list of magazines we wanted to be in and got their media calendars
- Purchased Bacon's Media Calendar list – offers over 3000 magazines
- Began major press push

June 2004
- Started sending samples to editors, and those on the CES tradeshow press list
- Researched target market (women/moms), digital camera market, photo processing, digital photos, photo retailers, market trends
- Work with International Supplies and their IPI customers. Make 100 calls for 8 sales.
- Commitment from Staples 5k units at 20 points with a $9.99 Key Ring for checkout at holiday
- Commitment from CompUSA 40K units at 25 points with a $12.99 package
- Attended J&R street event - daily specials
- Heavy sample push to dealers
- Kerr Drug Store- product launch – test
- Design Counter Top Displays for dealers – low introductory cost, sample of all products

July 2004
- Attended ECRM – focused meeting event with grocery and drug store buyers. These shows which last 3 to 4 days and provide direct access to many buyers, cost $15,000 each and were considered very efficient and successful in comparison to regular trade shows.
- Started getting free press and reviews from magazines we contacted
- Created product spec sheets for retailers and dealers
- Sent samples to the Home Shopping Network
- Began monthly calls with manufacturing partner, Brian and Al
- Heavy sample push to photo resellers for holiday gift guides
- Full page ad appears in Twice magazine (dealer rag) – little response
- Full page ad appears in Expose, ECRM's magazine –no direct response

August 2004
- Hired dedicated sales person
- Became aware of Computer User Groups- contact them to test/demo Pixifun to members.
- Internet search for Pixifun brings up a lot more matches now than a few months ago- magazine articles and reviews all coming up and other sites are picking up those reviews as well, doubling coverage on some reviews.
- Product in Biggs (ECRM contact) Grocery store
- ECRM follow up of leads continues
- Work with International Supplies on Project Bingo; give FREE Counter Top Displays to 25 dealers.
- Began weekly calls with manufacturer
- Conducted contest among employees to discover a new Pixifun products

- Attended J&R Jazz festival street show – had specials for the event
- Place products in test stores- local stationary, gift, photo processing
- I/O Magic introduces new, more attractive packaging
- Ad appears in Custom Gift Retailer – get leads for the next 4 months –few takers

September 2004

- Held 1st Annual Planning Meeting off site for selection of new products Collected 125+ ideas for meeting review and final decisions
- Displayed product at local Fall Festival- not much interest- people "scared" of the word "digital" photo. Not many of the people that attended the festival owned a digital camera- most liked idea of making things with photos but still didn't understand fully enough to want to purchase
- Staples ordered 8520 key ring kits
- Looked into Photo Sharing websites for possible Pixifun inclusion- discovered they don't allow advertising and most do their own gifts already
- Did wall display and two roto rack displays at J&R Computer Store in NYC

October 2004

- Exhibited in Fall PMA with International Supplies
- Started contacting magazines that will run Holiday Gift guides
- Met with local Toy Rep to see viability of getting into that market

November 2004

- Interview on a radio talk show "Castellini on Computers" out of Grand Junction Colorado
- Conducted further internet research on parenting and family magazines as well as newspapers across the country. Discussed need for new press release, with no new products
- Did research on Party Stores and how we would fit in with these retailers
- Product Midwest Cellular stores
- Commitment from Target
- Started work on new packaging design for Target- reworked Magnet package for Target – also reworked Key Rings and Stickers for our purposes; these designs were never released.
- Moved Photo Sticker Album to Photo Sticker with Mini Album to emphasis creating Photo Stickers
- Started weekly Key Account Update meetings to review accounts and status
- Sent holiday headers to stores with counter top displays
- Offered holiday promos wherever we could

December 2004

- Had 40 articles/reviews written about the product; all very positive. This was a result of contacting 1000 magazines, newspapers, and internet sites with a response rate of about 4%

- Received a great response from Computer User Groups. All very interested in demonstrating the product to their members. Found the Association of Personal Computer User Groups and decided to attend their tradeshow in Las Vegas so we could bring Pixifun to the attention of over 300 CUG directors/members from across the country.
- Purchased list of over 3100 newspapers for the country
- Offered FREE shipping on orders over $25.00 for the holidays

January 2005

- ·Exhibited at the APCUG Trade Show in Vegas
- ·Put together a "Presentation in a Box" for Computer User Groups. This box contains product samples, a PowerPoint presentation CD, product and t-shirt give away-s, product brochures with a special group discount, and product surveys.
- Designed product brochure for CUG's
- Send samples and brochure to Florida Association of Computer User Groups- also announced a special fundraiser for CUG's – no interest
- Dan promises new product samples and software- they do not arrive

February 2005

- Exhibited at PMA with International Supplies
- Attended QVC New Product Vendor Search –designed Photo Fun Pack – new Photo Pop-Up Ball and Photo Foldz
- Talk with other vendors with like product. Sell in good, sell out not where it needs to be. Consider Category Captain concept.
- Meet with Australian company that carried Pixifun too. Same story.

March 2005

- Met with Bob Caspe re: marketing ideas and infomercials
- Looked into a kiosk at the mall
- Looked into Cinema Ads/ Direct Mail options and establishing category captains
- Came up with Photo Phone Charm concept (first called Photo Phone Tags)
- Established a Fund Raising Program for schools - not sold aggressively
- Began extensive direct marketing research, teens buying habits research, and cell/camera phone research
- Decision made to develop our own online software for new product offerings

April 2005

- Product shipped to Target Stores – sales started last week of month

- Staples moved product to $3.99 in clearance section. Sales go from 60-70 p/wk to 500
- Researched phone charms- had potential with teens
- Dan’s new product samples arrive. Conduct internal survey to get responses. Few, if any items appear to be viable as new offerings.

May 2005

- Target lowered pricing to $7.99 after low sales first 3 weeks
- CompUSA moved pricing to $4.99
- J&R moved pricing to $5.99
- Met with Wal-Mart – likes idea- wants proposal on side kick
- Pexagon establishes a Global Sourcing department for quoting products

June 2005

- Had booth at local Tag Sale Event (sold key chains made on the spot)
- Designed new product packaging- poly bag design- emphasizing product not brand- going away from digital photos to using existing and making software a bonus offer (link to online software rather than CD in package) for those who want to use it but don’t have to. No more pre-sized, pre-cut paper- use photo paper and template to cut out photos.
- Magnet and Key Ring are assortment of shapes/3 per package
- Photo Sticker Album is different design, includes mini marking pens to design your own pages
- Photo Phone Charms packaging designed for poly bag
- Met with Brooks Pharmacy- wants proposal for “1/2 Cubby”
- 1st conference call with PIE to discuss category. Same experiences there.
- Sales at Target do not meet expectations. Entire category is not doing well.

General Comments

- Buyers love the packaging
- Sell thru is not what anyone expects
- The category is undefined
- The customer does not need the products
- Packaging revisions have been done to improve product recognition, cost and information
- Nothing has been spent in traditional advertising mediums (end user oriented)

Ongoing Marketing Duties

- Visit competitors web sites on a regular basis

- Do searches for new items
- Search for Pixifun and related items regularly
- Monitor local ads for promos and like items
- Shop in retail stores for product ideas, merchandising concepts and pricing
- Subscribe to an assortment of Scrap booking and related magazines and email newsletters
- Send press letters (new and repeat)
- Monthly (at least) Internal Meetings to discuss updates and focus
- Compile marketing data for presentations
- Continue to set up meetings with new retailers
- Compile ideas and suggestions for web site improvements and redo
- Stay in touch with current customers offering promos and merchandisers solutions

5.4.2.1 Case Questions

What would you do to create a successful marketing strategy for the Pixifun product?

Was this product in a new or pre-existing category?

How does this affect the marketing channel selection?

5.5 Internet Address Links

Harvard Business Online	http://harvardbusinessonline.hbsp.harvard.edu/b02/en/academic/edu_home.jhtml
Hologic	http://www.hologic.com/
Polymedica	http://www.libertymedical.com/
Frontline "Persuaders"	http://www.pbs.org/wgbh/pages/frontline/shows/persuaders/interviews/rapaille.html
Bright Smile Inc.	http://www.britesmile.com/
IDEO Inc.	http://www.ideo.com/
Claritas Inc	http://www.claritas.com/
Claritas sample report	http://www.claritas.com/collateral/segmentation/corp-col-2030-0605.pdf
Vivitar Corp.	http://www.vivitar.com/
Corbis stock photography	http://www.corbis.com/
ECRM trade shows	http://www.ecrm-epps.com/
Frontline "Wal-mart"	http://www.pbs.org/wgbh/pages/frontline/shows/walmart/interviews/lehman.html
Belden Corp.	http://www.belden.com/
American Experience "Tupperware"	http://www.pbs.org/wgbh/amex/tupperware/
Creative Memories	http://www.creativememories.com/
Spotrunner.com	http://www.spotrunner.com/
Cheap stock photos	http://www.istockphoto.com/
Direct mail lists	http://www.infousa.com/
Credit Card Merchant	http://www.2checkout.com/
Email marketing	http://www.constantcontact.com/
Domain name searching	http://www.networksolutions.com/
Domain registration	http://www.godaddy.com/
Freelance Programmers	http://www.elance.com/
Cheap bulk printing	http://www.gotprint.com/
800 number call forwarding	http://www.voice-plus.com/messageplus.htm
Flash templates	http://www.templatemonster.com/
Google Ad-words	https://adwords.google.com/select/main?cmd=Login
PayPal	https://www.paypal.com/
Small telemarketing company	http://www.goodleads.com/
Govworks.com movie	http://video.google.com/videoplay?docid=-5322831804239591897&q=startup.com&hl=en

Cheap Software Development	http://www.rentacoder.com/RentACoder/default.asp

5.6 Podcast Case Attachments

The podcasts that accompany this book are available to students on my website at http://www.caspegroup.com . In order to gain access to these cases you must first register by going to the menu choice: Alumni/Student/Login and create a new account. You will need a valid email address. To enable access to these videos, you will need to enter the following code when registering: VIDEO CODE – HKUZ93

5.6.1 Canditto – Interview 1, November 2009

Rush Hambleton attended Babson College's MBA program from 2007 to 2009. During that time he began an entrepreneurial venture called Canditto.

His concept was that candid wedding photos taken by guests were http://www.caspegroup.com/podcasts/canditto/podcast_canditto_nov09_main.mp3frequently preferential remembrances of the event, but were often lost to the bride and groom once the guests had left. Counting on the guests to email great shots wasn't a reliable way to get the photos.

Rush developed the concept of a small computer based box that would be placed near the exit of a wedding and into which guests would insert the memory cards from their own digital cameras. The images taken that day (literally, within the last eight hours) would be duplicated into a separate memory within the box and after the event, delivered to the wedding couple.

In the initial interview, Rush describes how he came upon the idea and how he tested it using some off-the-shelf computer parts at few weddings. After several months of testing, he contacted an old friend, Mark, who had moved to California. Mark was skilled in the art of hardware and software design and could possibly build Rush's product while still holding his full time job.

After some negotiation, Mark was convinced to join Rush as a minority partner and as the first outside investor in Rush's company. Mark provided initial capital of $100,000, part in cash and part in the labor and talent needed to design a more compact and economical product than the pieces that Rush was using thus far.

Rush and Mark did the deal on the basis of a handshake and now, in 2009, it appears that there might be a misunderstanding relating to whether Mark's equity percentage of ownership has anti-dilution privileges and will remain at 30% even if more equity is brought in by Rush. While Rush and Mark's relationship is still fine, this might become a real problem moving forward.

In the first interview, Rush shows the product that Mark developed and he describes some of the features that he believes are valuable. Each unit is hand assembled by Mark at a cost of around $750.

Figure 28 - Canditto

As well, Rush had a custom shipping case designed which is similar to a musical instrument case in order to better protect the device and allow for more convenient return shipping.

During 2008, Rush was able to raise another $60,000 in seed capital from an angel investor, however, by his own admission, the process of raising capital took an extraordinary amount of his time and focus away from the product development and marketing processes. With the additional capital, Rush was finally able to take a small salary and remove some of the pressure on his young family.

But, all during this time, Rush had not really focused on solving the question of "how to find and close sales at an economical cost?" Rush had felt, as he says in the interview, that at first he considered the marketing and sales part of the problem to be something that he should be able to handle since he, like all of us, are involved daily in marketing and sales programs executed by others. After over a year of attempting to find a profitable and scalable marketing and sales model, the solution still eluded him.

But it's not for a lack of trying. Rush has created several methods of marketing and selling (renting) his product including: an ad-words campaign and a rather elegant website with a flash tutorial on the product. He has purchased some web banner advertising and he has attended several bridal trade shows at which he rented a small booth. As well, Rush has successfully gotten a fair quantity of press coverage with The New York Times, Martha Stewart's Wedding Blog, Boston.com, several magazines and websites and he has developed six partner companies that help with sales. To start, he decided to set the rental price at $650 which includes free shipping both ways and two USB 2GB memory sticks (on which the pictures are delivered).

For the purposes of creating a Transaction P&L Rush assumes that the device will last 13 uses and therefore costs $50 per use. The shipping costs average to around $13 each way for a total of $26 and the memory sticks cost around $25 total. For our purposes we can assume that the costs associated with a transaction excluding marketing and selling total to $100. He is not yet accounting for the labor involved in managing the shipping process and customer service.

The first interviews with Rush were done in November of 2009. At this point, he had been unable to find a marketing process that was both profitable and scalable. For example, at a bridal show he might spend around $1,500 in marketing costs to close two sales at $650 which contribute only $550 each in gross profit or $1,100 total for the show yielding a net loss of $400. Rush clearly feels that he did not approach the sales and marketing problem early enough in his company's development. He is surprised at how hard it is to simply sell (or rent) his product.

Most recently, Rush has attended several trade shows and has been tuning his presentations and booth designs in the hope of generating more sales and in the belief that his sales presentation has been the primary problem.

Now his suspicions are that he has three problems:

1. He has priced the product rental too high.
2. The brides-to-be that attend the small bridal shows are far too early in the process to commit to a product like his that seems not to be central to the planning process.
3. He has a hard time transferring the value proposition to the potential client. Sometimes they "just don't get it."

At the most recent trade show, he and Erin, a fellow student who he hired to work the show, talked to around 50 potential clients (out of around 250 that attended the show). They closed six sales at an average price of around $250, which he now believes is closer the right price, but, he observed that most of the brides were one to two years from the marriage date and weren't yet considering products in this range. Unfortunately, the six sales at $250 still don't produce enough gross margin to cover the show costs.

5.6.1.1 Case Questions

At the completion of the first set of interviews, Rush is confronted with several real problems:

1. How can he create a better understanding of what the correct manufacturing cost, and eventually, what the amortized cost of the hardware should be for each transaction? Note that at different volumes, the manufacturing cost might be very different. What is the cost at different volumes?
2. When and how should Rush attempt to reduce the costs associated with each transaction? For example, it should be possible to buy USB drives more cheaply, and change the design so that it is better suited to shipping.
3. What can become a successful (profitable) and scalable marketing and selling method for this product?
    a. How can Rush achieve better media efficiency by contacting brides at the moment when they are most receptive to the product concept?
    b. How can Rush best articulate the value proposition to someone who has never organized a wedding?
    c. What is the correct pricing?
    d. What is the correct media channel?
    e. What is a strategy that can be used to determine the answers to all of these questions?
4. Should Rush raise more money and if so how much and from whom?
    a. What terms should be considered?
    b. How should he deal with Mark? Try to write a simple agreement that Rush could use with Mark, and possibly have used when he started.

5.6.2 Heatspring Learning – Interview 1, November 2009

Brian Hayden and Duncan Miller graduated from the Babson one year MBA program in spring of 2007. During their last semester at school they developed a business idea which was based upon their interest in starting a business in an environmentally responsible industry that would take advantage of rising energy prices. They selected geothermal heating and air conditioning as a growing opportunity.

Their first plan, which they worked on in several classes, involved their starting their own HVAC company that specialized in geothermal systems. Unfortunately, they soon discovered that the competitive landscape of HVAC companies would make it hard to compete purely on the differentiating value of offering geothermal systems. The barrier for other HVAC companies to learn about geothermal systems and neutralize their differentiator was low.

At that point, they stepped back from the problem and rethought how they could enter the industry. They developed no less than a dozen alternative business strategies and then went out, one by one, approaching potential customers to see if they could “close a deal” and thus validate one or more of the plans.

Duncan commented on how different and illuminating it is to engage with real potential customers as a first step in evaluating the rationality of a business plan. He states that “after just a few calls you know whether you have something of value that you’re selling.”

Soon, they had reduced the dozen alternatives to one, namely providing the education to HVAC, well drilling, general contracting and architectural companies in the field of geothermal heating and air conditioning.

Within less than one month from that decision, they created a direct mail marketing program, purchased a mailing list, engaged with a teacher (from another college) who could teach the course, found space at Babson to give the course and embarked on the process of signing up customers.

Together, they spent the next month on the telephone selling courses and by the end of the month had sold enough seats so that they were able to make over thirty thousand dollars in revenue before even finishing their MBA.

During their first few months of operation, they did everything as cheaply as possible down to borrowing space at school to operate their business. To save money, for example they purchased a pre-packaged web site from templatemonster.com, used their cell phones for calls and found an inexpensive VOIP service for their company phone number (Vonage).

The first full year of business involved substantial growth. By the end of the first year, they had grossed slightly over one million in revenue and had run roughly 35 classes with an average of 25 students per class. They had four employees, including the two founders.

At their 2009 annual planning meeting, they speculated that they would double sales in the second year of operation and should add two additional staff members bringing the total number of employees to six. In fact, the first quarter 2009 already had earned a half million dollars, half of the entire first year of operation.

At this same time, the bottom had fallen out of the US economy and we were all experiencing the largest recession since the great depression of the 1930s. Heatspring's sales fell in the second quarter of 2009 but they had expected this poor performance based on similar seasonality in 2008 and weren't particularly concerned as the company was still on track to double its revenue. They assumed that their business would continue to grow over 2009 and they would remain unaffected by the general recession.

Unfortunately, this was not to be the case and sales dropped significantly and unexpectedly in both the third and fourth quarter. At the same time, their expenses had grown to double, from $20,000 per month to $40,000. By September of 2009, the company had experienced losses in 4 out of the 5 previous months since they hired new employees. Their cash position had been cut from over $100,000 down to less than one month's operating expenses. October was looking as though it would be positive month for the company, but November and December were historically poor months for sales and they were expecting to continue losing money.

Brian and Duncan spent a fair amount of time trying to decide what the right course of action would be. All the while feeling the pressure of seeing their cash reserves diminish. They began to cut unnecessary expenses and asked their employees to take a pay cut. They were surprised how much could be cut with little or no effect. They remarked as to how easy it was to not pay careful attention to each expense detail and accumulate unnecessary expenses.

Eventually, however, nearing the end of their fiscal year, they came to the realization that if they continued to wait, they might get stuck in a situation where they would be unable to even afford to pay severance benefits to employees who would be laid off. All during this time they remained open with their employees about the dilemma that they all were in.

At that point, they chose to cut the company from six employees back to the initial two founders. By the end of 2009, their revenue had grown only 30% to 1.3 million instead of their expected 100% growth to 2 million. Drastically cutting overhead expenses, combined with laying off employees had brought their overhead down to around $10,000 per month. The difficult time had also forced them to push on vendors and lower their cost of goods sold.

Much to their surprise, they were able to run the company just fine with just the two of them and finally, after two and half years of operation, they were actually making money themselves. With just the founders running the company, the number of classes offered shrank along with top line revenue, but net profitability grew.

When asked what the future offered, they responded that they might choose to hire help on more of a contract basis instead of hiring employees and would continue to try to find business models that they could move to that would afford them growth.

One could tell during the interview how hard the downsizing was for both of them and how, in the short course of two years, they had amassed a wealth of experience in running a small company. They had learned about hiring, firing, cash flow, but most importantly, they were also coming to terms with the definition of success and what it truly means to be an entrepreneur.

At this point, Duncan is considering moving with his new wife back to Oregon and Brian is staying put and will continue to focus on Heatspring. He has several opportunities including even building his own brand of heat pumps and importing them from an Asian manufacturer that has no US distribution in place.

5.6.2.1 Case Questions

What lessons can be learned from observing Heatspring's rise and stumble?

1. How would you have managed Heatspring differently?
2. How would you define and measure success at Heatspring?
3. What would you focus on as a short term course of action?

5.7 OEM Contract Negotiation Information

Goal of the Exercise

Although we will be using negotiation as the method employed to find the right solution, unlike the negotiation class exercises that you may have done, this exercise is intended to be focused upon the content of the contract, not the winning of the negotiation. Thus, the goal is not simply to achieve the best results for the stronger party, but rather it is to use the negotiating process as a framework under which each team attempts to construct an agreement that will lead to the best possible outcome for both parties. Spend time thinking about what how the contract will serve the parties if the intended outcomes are not matched with reality.

Early in the process, it should be evident that between the parties there are enough resources to achieve a successful business venture. The key is to assemble a joint program that is fair to all parties and can sustain the stresses of the real world. Also, keep in mind that larger companies often have less flexibility because of political complexities and a large group consensus that may be required to ratify a deal.

Given this premise, however, it still may not be advisable for each side to completely open all of its information to the other side since it could radically shift the leverage and power over the form of the deal. Your mutual goal is to “close the deal.”

In general, when negotiating a complicated contract like this, it’s a good idea to try to move through all of the terms quickly and not get bogged down on any one term. Set a time limit of ten minutes on any one term. If you cannot come to agreement, then place it at the end of the list and move on. Return to those terms at the end. In this way, each side will feel that the contract is “almost done” and will be more willing to compromise on the remaining terms.

General Statement of the situation:

There exist two companies, Company L and S. This statement is visible to all companies.

Company L is similar to Motorola, a large, successful, $30B in sales, public manufacturer of cell phones and other products. They have strong brand and channel relationships. They were approached by Company S, a small high technology design firm, which is located in Monterrey Mexico to see if an OEM relationship is possible. Company S is a small privately funded group of engineers (approximately 10 people total) that developed a new “ground shaking” cell phone which they are calling the "ephone." Company S has shown the product in its current state to Company A and they are very impressed. Everyone knows that there's still some work to do in engineering and a desire to protect the IP with a patent. As well, no manufacturer has been selected yet. Everyone also knows that Company L is a strong manufacturing company and has their own manufacturing facilities both in the US and Asia.

No one really knows how many ephones can be sold. It's a function of the price, competitive environment and the economy. One can guess that the volume will probably be around 3,000 per month minimum. It could go as high as 30,000 per month if the product were a raging success.

Each Small company and Each Large company will have a chance to meet over the next week to see what kinds of agreements can be created. I would suggest the following process. Step 1: each side should independently create a proposed term sheet. Then when meeting for the first time, each side should present their own preferred version of "the deal." Next, each side should caucus on their own to come up with a counter offer that attempts to create a single agreement that is acceptable to everyone.

The terms that should be discussed should include, at minimum:

- Who manufactures the product?
- What is the payment method and amount to the small company on what dates?
- Who will own the IP and under what terms, what will happen in different geographic markets?
- What is the brand name of the product when introduced?
- What are the commitments and what will be determined over time?
- What happens if the small company goes out of business?
- What happens if the large company loses interest or goes out of business?
- What other types of protections are desirable by each company?
- Who provides the support, and under what terms?
- Who provides the additional software, and under what terms?
- What if the product doesn't do well in the market?
- What about new product developments that occur later on?

5.7.1 Large Company– READ ONLY IF YOUR BIRTH DATE IS ODD

The following information will help you to further understand your own limitations and objectives:

Company L – this information is not all available to the other team

- You're a member of a large company $30B in sales
- You have a strong brand in selling telephones and relationships with service providers
- You have a strong balance sheet with plenty of cash
- Your fiscal year is the calendar year
- Your engineering group already told you that they could do a better job than Company B but it would take two years and cost $2M in R&D
- Company B's product has not yet been tested for FCC compliance. This testing will take 3 months and cost $60,000.
- Company B's product has not yet been accepted by your marketing group as working without flaws.
- You have your own manufacturing facility in China and could build the product for $65
- Your world headquarters is in San Francisco CA
- You believe that the selling price at retail would be $250 and that the service provider would want 30% plus marketing support of 5% and distribution fee of 5% and rep fee of 5% But you're not sure that the retail price will hold for long because of competition
- You need to have this product in the US where you are strong
- You don't need to have this product for sale outside of the US but if you can get it, OK.
- You want to market it under your own brand name only
- You're concerned about patent infringement since it can lead to expensive litigation
- You need more software development for this phone and you're concerned that Company B might not have the resources. You perceive a need for 6 programmers for 6 months.
- You believe that you can sell 10,000 units without any risk in the first year simply as part of the launch, but you have no idea how

many units will sell per year once the product is launched. The market will determine the success of the product.

- Note that if you made a large deposit (more than $200,000) with Company B and they went out of business, everyone in your team probably lose their job.
- If the product is successful, you might like to acquire Company B but you have no idea what a fair price would be at this point since you don't know how many units will sell or what other business they might be able to get.
- If you buy the product from Company B you will need to qualify their manufacturer's quality. This will cost time and money. Getting a new manufacturer qualified might take 6 months and cost around $100,000 in travel and other costs.

5.7.2 Small Company– READ ONLY IF YOUR BIRTH DATE IS EVEN

The following information will help you to further understand your own limitations and objectives:

Company S – this information is not all available to the other team

- You have invented a new telephone called the ephone 3G
- You're a member of a small company of $500k in sales per year
- **You have a weak balance sheet with very little cash. Note that if you don't get some cash soon, you're going to run out of money.**
- **Your burn rate is $30k per month (salaries, benefits, fixed expenses) YOU NEED A MINIMUM OF 30K/Month + ADDITIONAL EXPENSES ASAP.**
- Your product has not yet been tested for FCC compliance. This testing will take 3 months and cost $60,000.
- Your fiscal year ends on the calendar year
- You have completed the development of the product but have not thoroughly tested it yet
- You can get the product manufactured in China for $75, no less. (Note that you don't have the cash to pay the required deposit for a large production order. Typically the manufacturer will require a letter of credit for the full value of the order before they are willing to ship it.)
- You want to develop your own brand in Europe and SA. You have found a distributor, who can sell your product for you in Mexico, but you don't have the money to start the manufacturing and the distributor has refused to pay in advance. You need $500,000 to get your manufacturer started.
- You have no plans yet for distribution in Asia
- You are located in Monterrey Mexico
- You believe that the phone can be patented but you have not yet patented it because you can't afford to. Getting a patent will cost around $50,000.
- You have limited programmer resources – only 3 programmers and you feel that the work needed to complete the project will require around 6 programmers for 6 months.

6 Glossary

Acceptable Product Packaging – when selling to retailers, they will define as part of the vendor requirements document what packaging is acceptable for your product. For example, a CD will require fitting into their CD racks. Some products require that they be displayed on pegs, others on shelves of specific heights.

Accounts Payable – the money that you owe to vendors. An aging report would show how long you have owed parts of this amount.

Accounts Receivable – the money owed to you by your customers. Note that there will typically be an "aging" reported that shows how old each owed amount is. Investors or bankers are concerned about which of these might not be collectable.

Analysis Paralysis – an industry term for implying that company is stuck in analysis and cannot make necessary moves as quickly as might be desirable.

Angel Investor – typically an investor who acts alone and is familiar with the industry, had some personal financial success and is interested in helping out new participants in the industry.

Angel Group – a group Angel investors who invest together but may also choose to participate individually in a deal. Angel groups act more like traditional venture firms.

Arbitration – when engaging in contracts, the parties can agree to methods of arbitration that attempt to avoid or potentially eliminate the ability of either party to use the legal system for relief. This can be much less expensive than a legal battle, but can offer less protection.

Assignment – when engaging in contracts, parties are interested in defining outcomes if either side attempts to sell or otherwise transfer their responsibilities to other parties that may include acquiring companies.

B to B or B2B – Business to Business endeavors. This is where your business sells products or services to other businesses as opposed to consumers.

B to C or B2C – Business to Consumer. These endeavors sell products either directly to consumers as in "direct marketing" or through channel partners that in turn sell the products to consumers. If a channel partner is used, there is also a B2B process for B2C companies.

Back to Back LC – When purchasing a product from a vendor who requires an LC to ensure payment, an intermediary can use an LC provided by their customer as security for the LC that will be issued to the vendor. These are referred to as being back to back.

Bank and Credit Card Clearing House – this company will execute the credit card charges and credit your bank account.

Brand Company – A company that sells a product or service under its own name. It may actually build the product, or it may use a contract manufacturer to build the product.

Brand Equity – the value of a company's name in the market.

Business Plan – A formal document that establishes business goals, and methods that are intended to reach those goals. The method might include pro-forma financials, organizational structure, product and service definitions, etc.

Cash Flow – a report that effectively shows your cash balance at the end of each time period.

Cash Flow Break Even – a cash flow that indicates that a company is neither accumulating or losing cash. Its bank account is staying even. Also referred to as cash flow neutrality.

CDA – Computer Design and Applications, Inc. One of Bob's companies that specialized in medical products.

Campaign P&L – A campaign Profit and Loss statement records all of the expenses and income associated with a particular marketing campaign. It does not include any statement of time. It shows whether a campaign is profitable and contributes margin to the company. It includes only variable costs associated with the campaign. The same as the Transaction P&L.

Category – A group of products or services that all directly compete with one another.

Channel Partner – An entity that buys your product for resale. For example, Wal-Mart is a retail channel partner for Sony which is a manufacturer and brand.

CEO – Chief Executive Officer (often synonymous with president).

COGS (Cost of Goods Sold) – the total cost of manufacturing a product and delivering to an FOB point. For service business it would include the variable labor costs and travel costs associated with delivering the service.

Common Stock – the class of stock that is typically given or sold to founders or employees as opposed to Preferred Stock.

Contract Manufacturer – A company that builds a product for another company that will sell it under their brand.

Convertible Debt – a loan to the corporation that can be changed into stock according to terms expressed in the loan agreement.

CTA – Call To Action. The statement made in advertising or on package design that a special offer is time limited and the customer must act immediately to take advantage of it. Note that it always is time dependent.

Customer Base – the generic category of potential customers for a specific product or service. It might be a category of business, for example, all garages, or it might be a specific demographic of consumer.

Customer – the person or entity that pays for the transaction. It is especially important to make the distinction between customers and "users" for website business where the customer may be an advertiser and the user might be a consumer that uses the site for other purposes.

Customer Service – the organization that is responsible for handling of customer questions, complaints, returns etc. but is not usually involved in sales. One exception is sometimes the customer service organization is authorized to offer a discount on a product that is about to be returned.

Depreciation Expense – these are expenses that are spread out over the useful life of an asset that you have purchase. For example, a particular machine might cost $100k and last for 10 years and therefore be accounted for as a $10k per year depreciation expense.

Destroy Selling – a method of selling that attempt to move to the close of a transaction. As opposed to Search Selling.

Dimensional Mail – Similar to Direct Mail except that the mailed item is larger than an envelope and by the nature of its size entices the recipient to open it more frequently.

Direct Mail – a marketing campaign that attempts to find customers by mailing information through the conventional mail systems: USPS, FEDEX, etc.

Direct Marketing – a method of marketing and selling where the manufacturer (or brand) company engages directly with a customer without a channel partner between them.

Distribution Strategy – A plan for how you will get your products to the customer. It may involve using distributors, channel partners, or direct selling on TV among many other choices.

Double Slit Experiment – a famous experiment first done by Young in 1903 that demonstrates a fundamental contradiction between wave and particle behavior of light an heavier particles.

Drunkard's Walk – a term invented by mathematicians to describe a random walk in two dimensions.

Early Stage Investor – an investor who prefers to invest when a company is just starting out.

Eighty-Twenty Rule – it is often observed in business that 80 percent of an attribute is caused by 20 percent of the unique cases. For example, 80 percent of the cost of a product might be represented by only 20 percent of the components.

Eligible Customer – an entity (either company or individual) who is qualified to purchase your product or service but may be lost as a customer because of either a competitor or because of a decision that does not involve your offering.

Entrepreneur – Someone who seems somewhat less concerned about risk and is more oriented to building a venture.

Escrow – an agreement between parties to allow a trusted third party to hold something of value to be released only under certain events as defined in the agreement. For example, escrowing design documents with your OEM partner's law firm can give them greater comfort in the event you were to go out of business.

Exclusivity – often, when constructing reseller relationships, the channel partner or OEM would like to be the only reseller within a specific territory or for a specific time in order to prevent margin erosion that occurs as a result of competition.

Financing Strategy – A plan for funding your business.

FOB (Freight On Board) – commonly referred to as a point in space where a price can be determined. For example, a particular product has a cost of $100 FOB Taiwan would imply that the product costs $100 delivered to the freight forwarder located in Taiwan. Shipping the product to the US would be extra. A purchaser might specify FOB Taiwan or FOB New York if they wanted the manufacturer to be responsible for shipment (and insurance) to the US.

Focus Group – a method for studying consumer preference that involves assembling and frequently paying a group of selected potential customers and asking them a series of questions that establish their tastes relating to a specific product.

Fulfillment House – This firm will pick, pack and ship your products. They may also provide simple telephone customer support and thus handle returns and RMAs.

Gaussian Distribution – named after Carl Friedrich Gauss, in probability and statistics, a distribution of events that center on the mean (average) and commonly applies to data that is based upon real world observations.

Gedanken Experiment – a thought experiment that is used to try to see if an outcome of a proposed experiment seems possible and likely.

General Operating Expenses – these typically include the labor, rent, electric, overhead, etc. that are not included in the other specific marketing, sales or research departments of your company.

Geothermal HVAC – Geothermal heating and air conditioning systems use the fact that the deep ground (and ground water) temperature is moderated and therefore offers a source of heat or cooling depending upon the air temperature.

Governing Law – when entities that live in different states or countries engage in a contract there is a need to define under whose laws the contract is interpreted.

Gross Profit – the net obtained by subtracting the COGS (Cost of Goods Sold) from the Gross Revenue.

Gross Revenue - all of your revenue combined regardless of its source.

Guerrilla Marketing – a concept of unconventional marketing that is supposed to achieve success at lower cost than conventional techniques.

Indemnification – often as part of contracts, one party will look to the other for financial protection against claims by others that patents or other rights were violated by one of the parties.

LC (Letter of Credit) – a financial instrument used to guarantee payment to a vendor. The funds are held in escrow by a trusted party, usually a bank, who releases the funds upon the presentation of the shipping documents that imply release of the product to the shipper.

Lead Generation – A method used to attempt to get potential customers to contact you in order to pursue buying your product or service. Often, advertising or direct marketing campaigns, like direct mail, are used to generate leads for you business.

Leaf Systems – One of Bob's companies that specialized in graphic arts computers, photojournalism products and digital cameras.

Lifestyle Business – often referred to in a pejorative sense as a business that is "about one's lifestyle" as opposed to being about growth. For example, opening a bar might be referred to as a lifestyle business.

List provider – This firm will rent you a list to a specific demographic that you define.

LOU – Letter of Understanding. Typically a non-binding agreement by parties indicating that they intend to enter into a binding agreement or contract.

Manufacturer – The company that actually builds the product.

MAP Pricing – Minimum Advertised Price. Retailers and manufactures agree to a minimum advertised price as a way of minimizing margin erosion while not breaking any laws and still allowing resellers to discount when the sale is being made below the MAP. Note that this is why on web sites you often cannot see the price until you start the checkout process.

Marketing - the process of communicating to eligible customers a transaction along with adequate value so as to convince the customer to buy.

Marketing and Sales Expenses – typically includes all the labor, travel and overhead costs associated with your marketing programs and selling your products.

MBA – Masters of Business Administration. The MBA is a post [under]graduate degree in business where one studies business processes.

Media – the communication channel used to send your message to your customer. It can be television, radio, mail, email, or even banging on the door.

Media Broker – for some remnant media types like television, radio and print, a media broker will buy media time (space) for your ad campaign. Most media types will require independent brokers.

Mezzanine Financing – a financing that typically occurs just before a public offering.

Moore's Law - is about the empirical observation, that at our rate of technological development, the complexity of an integrated circuit, with respect to minimum component cost, will double in about 18 months. (source – Wikipedia)

Multiple Preference – An agreement that Preferred shares are paid back at a multiple of the original investment if a liquidation occurs at a value below an agreed to value.

Multi-Tier Marketing – or Multi Level Marketing, a method of marketing that involves having your customers recruit resellers along with new customers. Each recruited reseller often shares some commission with the person who recruited them, and so on, up the chain.

NDA or Non Disclosure Agreement – A legal document that attempts to protect the originator of proprietary or confidential information from the damages that can be caused by leaking that information to others by holding the signatories liable.

Net Operating Profit – this number is the remainder after subtracting the marketing and sales, research and development, general operating and depreciation expenses from your gross profit.

Non-Compete – an agreement between parties that they will not directly compete in the marketplace. This is usually defined with respect to a specific product or service.

Non-Solicitation – an agreement between parties to not solicit any employee over to the other company.

Notices – when engaged in a contract there are specific people, addresses, and methods of communication that are required for indicating events.

OEM – Original Equipment Manufacturer, used in a way to describe a contractual relationship between two parties where one, the OEM manufacturer, sells a product to a "brand" company for distribution and marketing under the "brand's" identity.

PACS – Picture Archival and Communication System as used by hospitals to store and retrieve diagnostic images acquired through x-ray, CT or other modalities.

Parental Voice – the guiding voice of a parent or teacher who takes authority over the learning process and provides schedules, assignments and evaluation.

Peloponnesian Wars – fought from 431 to 404 BC between Athens and Sparta. Eventually, led to the defeat and demise of the Athenian empire.

Preferred Stock – similar to common stock except in preferences that involve rights and value in the event of a dilution (or sale) of the company. As well, there might be other rights that involve board representation, additional financing, etc.

Positive Cash Flow – a cash flow that provides an increasing cash balance over time indicating that a company is paying all of its bills and has cash left over which is accumulating.

Pro-forma P&L (or financials) – the predicted financial records of a company that might include the Profit and Loss statement (P&L), balance sheet and cash flow. Pro-forma financials might extend only a short time into the future, or many years.

Profit & Loss Statement (P&L) – a corporate financial statement that records the income and expenses of a company and demonstrates the profitability over time.

Prototype – usually a first version of a product that is build not for resale but only for demonstration of the viability of the design.

Purchase Order – the written commitment by a customer to purchase a product or service from a vendor.

Ratchet Agreement – an agreement to revalue stock at a lower price if a new offering is at that lower price.

Regression to the Mean – each time an event occurs that is not at the mean, the likelihood of the next event being in the direction of the mean from the former event is increased since the mean is "in that direction" and the mean is the most likely outcome.

Research and Development Expenses – typically include all of your labor, consulting services, overhead and materials that are associated with the development of new products. Note that in some countries, these expenses can be capitalized and depreciated.

Royalties – often as part of contracts, one side will assume all of the responsibilities to build and sell the product and the inventor is paid a royalty which can be based upon the sales volume, profit or other.

Search Selling – a method of selling that attempts to find new business opportunities, as compared to destroy selling.

Sales Pitch – the specific "speech" that you would give, or process that you would use when engaging a potential customer in order to convince them to purchase.

Self Reference Criterion – is the natural tendency to judge situations, beliefs and actions in different cultures according to one own cultural norms. (http://www.freebase.com/view/en/self_reference_criterion)

Sell Through – When using a Channel Partner, the sell through is the quantity of product that has been bought from you and sold through to an end customer by the channel partner.

Share Shift – When competing within a pre-existing category, competitors are attempting to win market share from their competition. Their objective is called a “share shift.”

Simulation – A computer program that allows you to “pretend” to participate in a real activity without real risk.

Sound Vision Inc. – One of Bob’s companies that specialized in consumer electronics including digital cameras and MP3 players.

Stock Option – an option to purchase commons shares that is often used as an incentive to work for and stay with a company. The option usually does not need to be exercised until the employee leaves or the company is sold or taken public. Option agreements have certain tax advantages for the employee. Often, the option to purchase shares is aggregated on a pro-rata basis over the option period, for example three years.

Suggested List Price – the manufacturer (or brand) will suggest the list price to a reseller. From this price, discounts are determined that specify the Transfer price to the retailer. Note that in the US it is illegal for manufacturers (or brands) to control the actual sale price which can be independently set by each reseller as they choose.

Tape Duplication – For television and radio broadcast, it is necessary to reproduce tapes with different telephone numbers in the call to action. Separate companies produce and distribute these tapes.

Telemarketing – This firm will answer the telephones and take orders. They can also be used to field customer service issues and outbound telemarketing

Termination – the terms under which and the events that transpire in the event that a contract is ended.

Territory – when constructing sales relationships, often one defines the geographic area or territory in which the reseller or agent can operate.

Transaction – a commercial event where money is exchanged for a product or service.

Transaction P&L – See Campaign P&L.

Transaction Selling – A structured process of selling that attempts to move the customer through a set of steps towards commitment.

Transfer Price – when selling a product through a channel partner or an OEM partner the Transfer Price is the price at which the product is sold to the partner as differentiated from the suggested list price.

Trial Close – a method of Transaction Selling that involves modifying the offer so that it removes the objections stated by the customer to see if the customer will now either commit or offer new objections.

Quantum Mechanics (or physics) – a sub-field of the study of physics that deals with the behavior of the tiniest basic particles of matter.

Value Proposition – the attributes of a product or service that serves as the motivation for a customer to purchase.

Venture Fund – an investment group that specializes in investing in higher risk companies with the expectation of greater returns. The source of these funds is often other investors, like pension funds, hedge funds, etc. that are looking to diversify their portfolio and get higher return along with higher risk.

Viral Marketing – a proposed method of marketing that involves saving money by using the spontaneous communication between people to spread the message about your product or service.

Voice Recognition – Computer recognized and interpreted voice commands.

Voice Synthesis – Computer generated voice.

Warrants – an agreement to offer shares of stock to be purchased in the future at a price that is agreed to now (or a formula that is agreed to now) and left to the discretion of the buyer.

Web Business – a business that operates entirely over the Internet.

Web Hosting Provider – This firm will host your website and maintain its presence on the Internet.

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