Recognizing and Shaping Opportunities

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INTRODUCTION

Chance favors only the prepared mind. —Louis Pasteur

"I would really like to be an entrepreneur . . . if only I had a great idea." This is a common refrain among aspiring entrepreneurs. It might seem that ideas for innovative products and services are out there, just waiting to be discovered by the lucky few. But as Louis Pasteur recognized more than a century ago, we must actually set ourselves up to be “lucky.” We must prepare our minds to recognize and create new ideas and then to shape them into opportunities. Consider how scientists come up with new discoveries, which are often the product of their education, professional and life experiences, and an ability to see patterns and relationships. Scientists learn a structured approach to identifying opportunities and solving problems called the scientific method, which frames the process of innovation leading to breakthrough discoveries. Successful entrepreneurs have the same kind of “prepared mind.” They are able to look at a familiar situation and see patterns and relationships that others have not seen. And they know how to take their ideas and shape them into opportunities to create value—for customers, investors, employees, advisers, and partners.

Coming up with an idea is just the first step in an entrepreneurial journey. Turning that idea into a compelling opportunity that inspires customers, partners, and investors to come along on the journey requires analytical capabilities, passion, and determination. (See the sidebar "How Is an Idea Different from an Opportunity?")

How Is an Idea Different from an Opportunity?

An entrepreneur might get an idea for a new venture by seeing patterns that suggest a solution to a compelling market need—one that customers may not even have identified.

An entrepreneur turns an idea into an opportunity by crafting a business model that identifies a strategy for targeting a market segment with a solution that will attract customers, partners, investors, key employees, and other resources that will be needed to enter and gain traction in the market and create value for all stakeholders. This value proposition will also include cash flow forecasts that reflect the entrepreneur’s assumptions for how the business model will generate cash flow once it is implemented.

Professor Alexandre Ardichvili and his colleagues define an entrepreneurial opportunity as “the chance to meet a market need (or interest or want) through a creative combination of resources to deliver superior value.” As we will see in the stories of the entrepreneurs we’ll meet in this reading, opportunities begin as unformed ideas that entrepreneurs shape and refine over time. Indeed, what begins as a vague idea from multiple streams of information and insight coalesces into what is often called a business concept, which later becomes a more focused business model that defines exactly which market will be targeted, which need will be met, which solution will be delivered, and which resources will be required to create value for all stakeholders, including investors.

Opportunity recognition and shaping can be thought of as comprising three distinct activities: (1) sensing or perceiving an unmet market need, or a new technology or capability that could meet a need that has yet to be identified; (2) discovering the fit between market needs and the capabilities and resources available to the entrepreneur; and (3) creating a
product, service, or a hybrid product/service “solution” that can be delivered to a specific market to address a specific need while generating value for all stakeholders.\textsuperscript{2}

As we will see, the novelty of an entrepreneurial opportunity influences the level of uncertainty in the assumptions that the entrepreneur must address in shaping the opportunity, which, in turn, influences the level of risk. This novelty relates both to the market need and to the capabilities and know-how needed to craft a unique, value-creating solution. To the extent that potential customers do not recognize an unmet need, market uncertainty and risk increase. To the extent that the capabilities and resources required to create a solution are not available to the entrepreneur, the technological, product, and financing uncertainty and risk increase.

This reading examines the process of identifying and shaping opportunities. Other readings in the \textit{Core Readings in Entrepreneurship} provide more detail on different aspects of founding a venture, including writing and pitching a business plan, attracting talent, building a business ecosystem, financing and scaling the venture, and harvesting value.

We begin with the stories of three entrepreneurial journeys. We then explore how entrepreneurs identify opportunities and end by discussing how they shape those opportunities by crafting business models and identifying risks and uncertainty. Although entrepreneurial ventures are usually formed in an iterative rather than a sequential manner—the founders are engaged in multiple parts of the new venture formation process simultaneously—for simplicity, we have laid out sequential steps in this reading. As you read, keep in mind the lessons John Connolly and his team learned in launching Mainspring, a strategic consulting and research firm that went public and was subsequently acquired by IBM in 2001:

Our company was started with an idea that reflected our understanding of what the market needed, new technologies that could meet those needs in ways that could not be done before, and an understanding of the resources and capabilities we would need to make the business a success. But it was our ability to be able to listen to our customers’ feedback to that concept that helped us better understand the real need and build better products and services. Our process was the following: develop a concept, engage the market, and then iterate, iterate, iterate; engage the market and then iterate, iterate, iterate; and keep engaging the market and iterating.\textsuperscript{3}

This reading concludes with two Supplemental Readings. Supplemental Reading 3.1, “Designing an Entrepreneurial Apprenticeship,” identifies approaches entrepreneurs can use to develop the experience and networks needed to recognize and shape opportunities. Supplemental Reading 3.2, “Comparing Business Models,” includes an interactive exercise that enables the reader to compare three business models a company is considering as it contemplates how best to grow.
ESSENTIAL READING

2.1 The Path to Entrepreneurship: A Tale of Three Ventures

If I had asked people what they wanted, they would have said faster horses. —Henry Ford

When Henry Ford turned 40, he had been trying unsuccessfully for many years to get his vision for a “horseless carriage” accepted by the market. By the time he turned 50, he had launched Ford Motor Company and was well on his way to becoming a millionaire.4 Many people believe that entrepreneurs develop brilliant new products while tinkering in garages, emerging only when they have a terrific product that is ready to sell to eager customers. But that myth is often shattered by reality. Indeed, few blockbuster business ideas start out as a brilliant insight that reveals large, uncontested markets. Instead, they are usually identified over a period of years by people who are tightly connected to varied sources of information—especially information gleaned from dense networks of relationships that span traditional industry boundaries.5 Entrepreneurs identify patterns as they engage deeply with others and are able to apply what they are learning to meet a need within a market, at times before the potential customers in that market even recognize the need—like the future car owners who might have thought they’d be content with faster horses. Entrepreneurs are passionate and persistent, continually experimenting, adapting, and learning as they shape an idea into a viable business.

Before we discuss the process through which entrepreneurs recognize and shape opportunities, let’s consider the spark that fueled the imagination and passion of the founders of three entrepreneurial ventures. As you read these vignettes, consider how the entrepreneurs identified patterns and created a solution, then analyze their approach to transforming their initial idea into a focused opportunity that defined how they would enter the market and begin experimenting, learning, and refining.

Leo Fernandez: From Corporate Executive to Entrepreneur

Leo Fernandez, a Cuban-born immigrant to the United States, left college and enrolled in the military in 1968.6 After returning from serving in the Vietnam War, Fernandez kept a promise to his mother, who had died while he was in Vietnam—he finished college, graduating with a degree in accounting and finance. He then joined Procter & Gamble (P&G) as a salesman but left after seven months when, despite having made his annual sales quota in the first three months and tripling sales in his territory, he received a salary increase of only 10%. In 1975 he got a job at Johnson & Johnson (J&J) selling surgical instruments in New York City. Less than a year later, he was promoted to the head of sales for Latin America. Over the next nine years, he changed positions several times within J&J, launching new businesses for the company in each role.

While working for J&J in Spain, Fernandez noticed that US pizza chains were beginning to catch on there. He also recognized that Spanish mothers were increasingly entering the workforce, and he believed they would welcome having meals delivered to their homes at the end of a busy day. Having been a customer of fast-food chains in the United States such as McDonald’s and Domino’s, Fernandez knew that the US business model would not meet the
needs of Spanish families with small children, who tended to dine together at home and preferred healthy meals. So, in the fall of 1987, Fernandez opened a pizza store near his home that delivered pizzas along with healthy side dishes, such as salads, to families in his neighborhood. The store was so successful that he opened a second store one year later and quit his job at J&J. “I always went my own way. I wanted to be my own boss,” he explained. “I had only small savings, less than $100,000, and was getting a divorce in my late 30s. Nevertheless, I felt confident in my future. I decided to go it on my own.” Using lessons he had learned at P&G and J&J on building a successful brand, Fernandez expanded the operation quickly, creating state-of-the-art marketing, franchising, and human resource (HR) systems to ensure rapid market penetration, consistent service operations, and the management depth needed to support growth.

The result was Telepizza, a rapidly growing company with highly profitable stores. Telepizza ended 1989 with 8 stores and 1990 with 18. By 1993, there were 121 Telepizza stores—roughly 70% franchised. In 1996, Telepizza went public on the stock exchange in Spain. By 1997, the company had a market capitalization of $1.7 billion, revenues of $294 million, and 467 stores. But, when he attempted to explore new businesses by opening new “fast casual” restaurant concepts (e.g., TeleGrill and TeleOriental), the company’s successful growth strategy faltered. While Fernandez initially thought that the new restaurants would appeal to the same market as Telepizza, he soon learned that the new restaurant concepts did not appeal to his existing market. As investors learned that Telepizza could not deliver on its growth forecasts, the stock price tumbled and Fernandez stepped down as CEO. Learn more about the issues entrepreneurs like Leo Fernandez face when confronted growth challenges in Core Reading: Scaling Entrepreneurial Ventures (HBP No. 8082).

Robin Chase and Antje Danielson: From Playground Conversation to High-Growth Business

In 1999, when Robin Chase and Antje Danielson identified the opportunity to start the car-sharing business that would become Zipcar, the two were 42-year-old mothers with children attending the same kindergarten. Danielson, a PhD environmental researcher working on an interdisciplinary project on energy consumption and greenhouse gases at Harvard, had just returned from a visit to her home in Berlin, Germany, where she had been impressed by the environmental impact of a new car-sharing service that was catching on in Europe. Chase, who graduated with an MBA from MIT with a specialization in applied economics and finance and had worked as a strategy consultant, had left the workforce when her children were born. She was looking for a flexible opportunity to return to work once her youngest child entered school full-time the next year. The two met in a nearby coffee shop to sketch out the concept, and then Chase used the skills she had honed in business school and as a consultant to analyze the market potential for a car-sharing service in Cambridge, Massachusetts. She sought advice from a former business school professor and mentor, who loved the concept but believed that the opportunity was much bigger than the founders had forecast and encouraged them to seek outside financing.

Chase talked with her family about whether the time was right to launch a high-growth entrepreneurial venture that would require a significant amount of her time but that could significantly decrease urban pollution and thus mitigate its health consequences. Picking up on both the economic and social effects of the venture, Chase’s 12-year-old daughter summed up the family’s sentiments: “Are you kidding? You could make money and save so many children’s lives if this succeeded. You should absolutely do it.” With the support of her family and her mentor, Chase expanded her market analysis; talked with potential customers at bus stops, in subway stations, and on college campuses in order to understand their needs; selected the company name; and developed a business plan that she began pitching to investors.
Danielson, who was still working at Harvard, contacted the car manufacturers that were participating in her research project to secure their support, assessed whether they would be willing to lease cars for the new venture and estimated the costs of those leases.

As Chase talked with friends, former classmates, and family members, she found that some were willing to help her finance the new venture. From the fall of 1999 to September 2000, she raised $375,000 in convertible debt. The car-sharing service was incorporated as a company in January 2000 and officially launched in Boston in June 2000.

Between 2002 and 2010, Zipcar raised over $50 million in venture capital (VC) financing, which enabled the company to shift to high growth. By its April 2011 initial public offering (IPO), Zipcar had grown to more than $186 million in revenue and had a fleet of over 8,500 cars serving more than 550,000 “Zipsters” in over 50 cities in the United States, United Kingdom, and Canada. In January 2013, Avis Budget Group purchased Zipcar for $500 million. We will discuss how Chase tested and refined her business model later in this reading. Learn more about transitions in the Zipcar founding team in Core Reading: Attracting Talent and Building Ecosystems (HBP No. 8068).

Evan Williams: From Farm Boy to Social Media Star
Most people have heard of Twitter, but many have not heard of one of its co-founders and early CEOs, Evan Williams. Even those who know of his connection to Twitter may not know that Twitter was originally launched as a product for use by employees of his firm, Odeo—which eventually failed. Williams’s entrepreneurial journey illustrates that ideas for new offerings often arise when entrepreneurial ventures fail to live up to their promise.

Evan Williams grew up on a farm in rural Nebraska and dropped out of college in his sophomore year, feeling it was a “waste of my time”; he wanted to “get my own thing off the ground.” His initial idea was to start a small, owner-operated direct-marketing company, so he spent his first year out of college apprenticing with a direct-marketing guru in Florida. In 1993, Williams returned to Nebraska and persuaded his father to finance his direct-marketing business and then convinced his girlfriend and brother to join him. But they had difficulty finding an initial market for their consulting service until a chance encounter with a new technology at the time, the World Wide Web, shifted their focus from direct-marketing consulting to website development. But over the next three years, as the founders attempted to build websites that could be launched into businesses, their excitement about this new technology waned. “I realized that I had started 32 projects the previous year and hadn’t finished any of them. I was constantly thinking up new ideas and found it better to abandon the current project to work on the new one. I was very short-sighted.”

When his girlfriend moved to San Francisco, Williams followed and answered an ad to work as a marketing coordinator at O’Reilly Media. Williams credited his nine months at this company as critical to his later success as an entrepreneur. “I shouldn’t have tried to [launch a business] without working in one first. I learned basic things like how to run a meeting and how to develop software.” He put these insights to work as he once again struck out on his own, working as a contract web developer while searching for his next idea. To meet his own needs as an independent developer who had to work closely with others, he built a set of web-based collaboration tools that enabled him to share updates with clients and collaborate on projects. These tools became the foundation for the 1999 launch of his next business, Pyra Labs, and its first product, Blogger, a multiuser blog service.

While Williams struggled to develop a viable revenue model, Blogger became increasingly popular among the growing number of web development enthusiasts. To keep the product alive, in 2000 Williams scaled back the organization and brought in $50,000 in financing from his old employer, O’Reilly Media, and from Condé Nast. In 2001, Dan Bricklin, an avid user of
Blogger and the founder of VisiCalc, the first spreadsheet application, offered to help Williams build a viable business model, as Bricklin adapted Blogger for use with his latest venture’s products. With Bricklin’s help, Blogger shifted to growth mode, and it became clear to Williams that he would need significant financing. In 2002, Tim O’Reilly, the founder of O’Reilly Media, introduced Williams to Google’s founders, Sergey Brin and Larry Page. In 2003, Google bought Pyra Labs and Blogger for a reported $10 million in Google stock that vested immediately. In August 2004 Google went public at $85 per share, raising $1.67 billion and boosting its market capitalization to $23 billion.

Williams, now a wealthy Google employee, began searching for his next venture. During his long commute from his home in San Francisco to Google headquarters, Williams listened to music on his iPod—a product launched by Apple in 2001. He could purchase music from the iTunes Store, which had been launched by Apple in 2003, but he could not purchase any other audio content. It just so happened that his neighbor had developed an audio podcasting product. Williams resigned from Google and, with his neighbor, launched Odeo, a company that would develop and deliver audio content that consumers could access over the web and run on their iPods.

Given that audio content was a hot new market opportunity and that Williams was a proven entrepreneur, Odeo quickly raised $5 million in VC financing. But the Odeo team struggled to develop a viable product. After learning that Apple would soon release a new version of iTunes that would deliver podcasting content, the team went back to the drawing board but, after burning through significant capital, failed to retain investors’ support. In early 2006 Williams stated that “the excitement was gone, the fun had ended.” He felt the creativity had been sucked out of him. Rather than shut down the company, however, Williams negotiated with his investors and partners to buy out their stakes.

Now the sole owner of Odeo, Williams, along with his small team, began looking for a product to commercialize. The spark for a product came when Jack Dorsey, an undergraduate student at New York University, pitched his idea for a microblogging site to Williams and the Odeo team. After a daylong brainstorming session, Dorsey was asked to join Odeo to commercialize his idea. The Odeo software development team originally used the initial prototype of the product, which the team named Twitter, for collaboration as they worked on a commercial version, which was launched as a stand-alone product in July 2006.

The tipping point for Twitter’s popularity came when it was used at an interactive media conference shortly after its public launch. Twitter executives streamed Twitter posts with real-time news about what was happening at the conference on two plasma TVs placed in the lobby of the event venue. In 2007, Twitter was spun out as a separate company and, over the next few years, its valuation surged, along with its user base. In 2008 Twitter’s valuation was estimated at $100 million. In October 2013, when the company announced its IPO plans, its value was estimated at $9 billion. On November 7, 2013, Twitter’s stock started trading on the New York Stock Exchange at $26 per share and closed the day at $44.90, with an implied valuation of approximately $31 billion.

**Lessons from Three Entrepreneurial Journeys**

Every entrepreneur’s journey follows its own twists and turns, but let’s consider some of the important similarities in the stories we’ve just read. First, these entrepreneurs all had personal, educational, and professional experience and networks that helped them spot the kernel of a good idea in emerging trends. Leo Fernandez recognized that US fast-food chains were beginning to enter the Spanish market but were having limited success. He drew on his marketing and sales background, his firsthand experience and knowledge of Spanish culture and family life, and his own gut instinct to design a concept that fit the needs of the market and would allow him to scale quickly. Antje Danielson’s experience as an environmental
researcher enabled her to recognize that the growing interest in car-sharing services in Europe could point the way to a solution to energy consumption and greenhouse gas problems. When her vision, experience, and contacts were combined with Robin Chase's contacts and analytical skills, honed while receiving her MBA and as a strategy consultant, the pair was able to build a business model that turned their idea into a viable opportunity that could be launched and tested in the Boston market. Evan Williams’s initial idea to start a direct-marketing firm shifted when he was introduced to the Internet and the first commercially viable prototypes of the World Wide Web and browser technologies. This spark initiated a long search for ideas that could be turned into viable businesses, as he first launched his own web business, then worked for an established marketing firm that was an Internet pioneer. His work as a consultant developing websites, coupled with the growing trend of using the Internet for communication and collaboration among the web development community, provided the spark for Blogger, which was eventually refined and sold to Google. All these experiences and his growing network of contacts eventually led him to identify the potential of microblogging.

Second, these entrepreneurs recognized that having an idea was just the first step; they needed to shape it into a viable business opportunity by engaging with potential customers, advisers, and experts and by searching for information that could help them link their understanding of a compelling market need to a unique and compelling solution. Leo Fernandez began by opening his own pizza store near his home and running it while continuing to work at J&J. Robin Chase applied her analytical skills to shape Zipcar’s car-sharing opportunity and sought feedback from other people, including an MIT professor, a former classmate who was working for a local VC firm, and customers at bus stops, in subway stations, and on college campuses, while Danielson spoke with automakers and other industry participants to get their perspective and support. Evan Williams shows us the dogged determination and passion that the entrepreneurial journey requires: He spent decades learning from seasoned executives and his own multiple failures as he experimented in the marketplace, attempting to shape his many ideas into promising opportunities. While Blogger was purchased by Google, only one of his ideas—Twitter—became a successful independent business.

Third, these entrepreneurs narrowed their focus to find a market entry point that could be tested, refined, and then used as a platform for developing the business to its full potential. In a blog post in 2005, Williams provided insights into what he had learned during his entrepreneurial journey. His first words of advice: “Be Narrow: Focus on the smallest possible problem you could solve that would potentially be useful. Most companies start out trying to do too many things.” Another tip: “Be Agile: . . . Many dot-com bubble companies that died could have eventually been successful had they been able to adjust and change their plans instead of running as fast as they could until they burned out. . . . Initial assumptions are almost always wrong.” Leo Fernandez went through multiple iterations when launching his first and second pizza stores—continually enhancing his pizza and side dishes to appeal to Spanish families, and improving his operating model to motivate store managers and personnel while improving efficiency and reducing costs. Even after extensive market research and the development of a detailed business plan, some of the assumptions underlying the initial business model may be wrong, requiring the entrepreneur to revise important elements after launch.

Having considered the experiences of several entrepreneurs, we’ll now take a closer look at how entrepreneurs embark on the path of launching a new venture.
2.2 Recognizing Opportunities

Intuition has long been viewed as a less effective approach to critical reasoning when compared to the merits of analytical thinking. Yet as society and businesses place a greater emphasis on the speed and effectiveness of decision-making, the intuitive approach has been identified as an increasingly important tool. —Michael Pratt

Research has shown that professionals and experts rely on two forms of thinking when making decisions. The first, \textit{intuitive (gut) thinking}, is creative, associative, and fast. It is good for finding patterns and recognizing ideas. The second, \textit{analytical thinking}, is controlled, rational, and relatively slow. It is useful for solving problems by breaking them down into their components.

Both kinds of thinking are critical for entrepreneurs. While they're generating ideas, entrepreneurs often rely primarily on intuition, which helps them recognize trends and patterns that indicate potential opportunities. They often go beyond their gut thinking by networking with potential customers, suppliers, and advisors. Shaping the opportunity into a business model often requires a more analytical, rational process of developing hypotheses, testing them through experiments in the marketplace, and then adjusting (or abandoning) the business model accordingly.

This section of the reading focuses on the process that’s often called “idea finding.” The following section explores how to shape an idea into a viable business opportunity that can be tested in the marketplace.

Sources of New Venture Ideas

Jeff Timmons, whose book \textit{New Venture Creation} was a best seller for many years, called good ideas a “tool in the hands of an entrepreneur.” Indeed, finding good ideas is the first step in the entrepreneurial process. Successful entrepreneurs are able to recognize patterns before an opportunity takes shape. They search for ideas at the intersection of markets, industries, and emerging technologies. They seek disruptors that will “unfreeze” a stable industry and look for business models that worked well in one market and can be adapted and applied in another. They recognize that they must listen to customers but sometimes need to educate the marketplace about new approaches. They learn to identify ideas by looking up from day-to-day activities and expanding their vision. They then set priorities and narrow the ideas they generate into a potential opportunity that addresses a compelling problem for customers that are able—and willing—to pay.

In a study of successful startups, Amar Bhidé identified the key sources of the ideas that formed the foundation for \textit{Inc.} magazine’s fastest growing companies in 1989. Though it was commonly taught that entrepreneurs conduct extensive research and analysis to identify opportunities before launching a new venture, Bhidé found that only 4% of the entrepreneurs in his study actually did so. Whereas 5% of founders explained that they had been “swept into the PC revolution,” 20% discovered their opportunities serendipitously—for instance, while working in a temporary or casual job or after reading a newspaper article. The majority of entrepreneurs in the study, 71%, replicated or modified ideas encountered through previous employment. In addition, he found that entrepreneurs “use a quick, cheap approach that represents a middle ground between planning paralysis and no planning at all. They don’t expect perfection—even the most astute entrepreneurs have their share of false starts.”

\textbf{Exhibit 1} presents the sources of the ideas for the three ventures discussed earlier, along with some relevant background and company information.
## EXHIBIT 1 Sources of New Ideas for Entrepreneurial Ventures

<table>
<thead>
<tr>
<th>Source of Idea</th>
<th>Sample Successful Ventures (Key Events &amp; Performance)</th>
<th>Relevant Background of Key Founders</th>
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| Replicated or modified an idea seen elsewhere | **Telepizza**  
Launched 1987; IPO 1996; acquired 1999  
1998 revenues $349.0M  
1998 profits $21.0M  
1998 valuation $2,267.0M | **Leo Fernandez**  
- Age 40 at founding  
- BA, accounting and finance, Stetson University, Florida  
- Worked in marketing, sales, and international management at P&G and J&J in the United States, Latin America, and Spain  
- Tired of working for others (“wanted to be my own boss”); saw changing demographics in Spain as women began entering the workforce; US pizza franchises not getting traction, owing to lack of fit with Spanish culture; decided to launch a pizza delivery service targeted at Spanish families in his neighborhood. |
| Chance encounter with co-founder | **Zipcar**  
Launched 2000; IPO 2011; acquired 2013  
2012 revenues $279.0M  
2012 profits $14.7M  
2012 valuation $540.4M | **Antje Danielson**  
- Age 42 at founding  
- PhD, geochemistry, Freie Universität Berlin  
- Worked as an energy research scientist at Harvard when she visited Europe and used a car-sharing service.  
  
**Robin Chase**  
- Age 42 at founding  
- MBA, MIT  
- Worked as a strategy consultant before taking time off for children; looking for part-time work when she talked with Danielson on school playground and the two decided to pursue the car-sharing idea. |
| Chance encounter with co-founder | **Pyra Labs (Blogger)**  
Launched 1999; acquired by Google 2003  
2003 revenues N/A  
2003 profits N/A  
2003 valuation N/A | **Evan Williams**  
- Age 27 at founding  
- Attended University of Nebraska, dropped out sophomore year  
- Apprenticed with Florida-based direct-marketing guru  
- Founded unsuccessful web development company  
- Co-founded Pyra Labs, which developed Blogger  
- Sold company to Google in 2003; joined Google |
| Chance encounter with co-founder | **Twitter**  
Launched 2007; IPO 2013  
2013 revenues $665M  
2013 profits $(645M)  
2013 valuation $30.2B | **Evan Williams**  
- Age 35 at founding  
- See early bio, above  
- Left Google after less than two years, when Google went public and he was able to exercise options  
- Co-founded Odeo as a podcasting company  
- Odeo failed to gain traction when Apple introduced iTunes Store  
- Bought out investors to regain control and developed an idea (after meeting Jack Dorsey, an NYU student) for microblogging that was used internally and then was commercialized as Twitter (recall how Williams followed the same approach in launching Blogger) |
As these examples demonstrate, there is no single path that entrepreneurs follow as they identify the ideas that may become valuable businesses. Indeed, “idea finding” can best be described as a creative process through which entrepreneurs draw on their intuition, developed through personal experiences and expertise, and on a network of relationships with others who offer fresh perspectives. Chris Anderson, the curator of the highly influential TED Talks, which bring together experts from a wide variety of disciplines to share new ideas that can change the world, explains the importance of expanding one’s horizons and identifying patterns and connections when searching for new ideas:

Creativity and insight aren’t things that happen to an individual only in a lab or in an artist’s loft. They are often sparked by ideas out of left field. The prevailing view has been that knowledge has to become more specialized; we were all told that to achieve something, we needed to dig narrowly and deeply in our subject matter. . . . [But everywhere you look today] you see convergence. Biology is transformed by computing power, while software is transformed by ideas from biology. New insights into human psychology rewrite the ground rules for product designers and markets. The same strange science that explains the synchronization of the human heart turns out to be linked to how the Internet self-organizes. Agents for social change model their organizations on business start-ups, while entrepreneurs infuse their businesses with idealism.19

The Idea-Finding Process: Creativity in Action

Harvard Business School professor Teresa Amabile’s research on creativity and innovation provides a useful approach for entrepreneurs. Creativity, she explains, is not just about imagination and inventiveness—what we may think of as “creative-thinking skills.” It also involves two other components: expertise and motivation.20 (See Exhibit 2.)

These three components help frame how entrepreneurs recognize opportunities. Expertise includes the experiences, education, and knowledge of the individual entrepreneur and of co-founders and important contributors. The larger and more varied the expertise network, the broader the space within which an entrepreneur can search for patterns during early stages of the creative process. Recall how Evan Williams’s early attempts to launch a web development business with his girlfriend and brother were thwarted by his limited personal expertise and by the limited expertise in his network. The actions he took to broaden his expertise by working at O’Reilly Media and Google and to widen his network by moving to Palo Alto enabled him to recognize the microblogging idea that eventually became Twitter.

EXHIBIT 2
The Three Components of Creativity

Motivation refers both to internal passion and interests and to external rewards. Though the many factors motivating individuals to pursue entrepreneurship vary,21 Amabile has found that internal motivation is an especially strong driver of creativity, because it fuels the passion and ambition needed to persevere through the many false starts of developing a new business. Recall how Leo Fernandez was tired of working for others and wanted to be his own boss when he left J&J to found Telepizza. For Robin Chase, Zipcar was a way for her to return to work once her children were in school full-time, whereas for Antje Danielson the venture was an important part of reducing dependence on oil and other fossil fuels—a concern that was central to her research. Co-founders often have different internal motivations, and as those familiar with Zipcar’s evolution know, different motivations can lead to conflict. Approaches for identifying and managing such conflicts are discussed in Core Reading: Attracting Talent and Building Ecosystems (HBP No. 8068).

Creative-thinking skills include the ways people approach and solve problems and put existing ideas together in new combinations. These skills enable creative individuals to see new patterns among diverse streams of information and to refine these patterns until they identify a solution to a market need—often before those who will eventually adopt it have fully defined that need. In a 2009 Harvard Business Review article, Jeff Dyer, Hal Gregersen, and Clay Christensen take a close look at creative thinking, identifying five discovery skills that characterize the most innovative and successful entrepreneurs:

- **Associating.** Connecting seemingly unrelated questions, problems, or ideas
- **Questioning.** Asking questions that challenge conventional wisdom and the status quo
- **Observing.** Scrutinizing common phenomena, particularly the behavior of customers
- **Networking.** Cultivating a network with diverse perspectives, expertise, and experiences
- **Experimenting.** Reducing uncertainty by designing focused experiments to test assumptions and “learn by doing”22

Learn more about how entrepreneurs use these discovery skills throughout the process of launching and expanding successful businesses in Core Reading: Becoming an Entrepreneurial Leader (HBP No. 8051); see the Entrepreneur’s Toolkit in the Supplemental Reading section of that Core Reading for a summary of approaches that entrepreneurs can take to improve their expertise and creative-thinking skills while recognizing their motivations.

2.3 Shaping Opportunities

People come in with business plans and, I mean, I know that no one is going to meet everything they say in a business plan. But you got to have something to . . .

—Arthur Rock

There has been extensive debate in entrepreneurial circles about whether the decision to invest in a new venture should be based on the strength of the “jockey” (the founding team) or the “horse” (the business model).23 In their book The Money of Invention, Paul Gompers and Josh Lerner found that experienced venture capitalists had different perspectives on what was most important to them when making investment decisions.24 Though most said that the strength of the team was critical to their decision to invest, many also reported focusing on specific aspects of the business model. For example, Tom Perkins, a founding partner at Kleiner Perkins Caufield & Byers, said that he considered whether a new venture’s technology was
proprietary and superior to others’. Don Valentine, a partner at Sequoia Capital, looked for a large and growing market.

Not all entrepreneurial ventures need VC investors in order to launch and transition to growth, but all successful entrepreneurs who wish to launch and grow a successful high-impact business are advised to craft a business model that identifies the unique strategy they wish to pursue, defines the resources and capabilities required to execute the strategy and identifies how the founders will assemble them, and explains how the venture will deliver compelling value to all stakeholders.

These three components of a business model—strategy, capabilities, and value—inform the series of decisions an entrepreneur must make about how to shape an initial idea into a business opportunity that can be launched and tested in the marketplace. The business model makes explicit the assumptions underlying these decisions, which, in turn, form the foundation for an entrepreneur’s cash flow forecasts—which are crucial for charting the early course of the venture and, ultimately, for identifying and attracting potential investors. The level of uncertainty in key business model assumptions—such as the size of the market, the features and pricing of entry products, the willingness of customers to adopt and the rate at which they will adopt, the availability of talent and resources, the nature and timing of cash flow and financing needs—enables an entrepreneur to define the experiments that must be conducted through early tests in the marketplace. The results of those experiments often suggest that certain aspects of the business model need to be changed or refined and, at times, that the entrepreneur should abandon an idea.

A Very Brief History of the Business Model

During the late 1990s, dot-com executives and Wall Street analysts routinely justified high valuations simply by claiming the superiority of emerging Internet business models without attempting to prove that the assumptions behind them would eventually drive cash flow and profitability. The dot-com crash in 2000 caused many to question whether the concept of a business model had been invented simply to justify get-rich-quick Internet schemes. But this is far from accurate. In fact, the concept of a business model can be traced to early management thinking about how to build sustainable, high-growth businesses in the industrial economy. Published in the 1960s, Alfred Chandler’s *Strategy and Structure* provided an important foundation for defining the economic models on which industrial-age businesses were constructed. This book described the importance of the alignment of an organization’s strategy with the environment within which it operated and with the resources and capabilities required to execute the strategy. It then showed how this alignment drove capital-efficient profitable growth and created value for all stakeholders. Chandler’s work, combined with a large body of increasingly sophisticated management research, laid out the theory of industrial economy business models that guided management practice through much of the last three decades of the twentieth century.

By the 1980s, industrial economy business models had become so well defined that the approach to analyzing them was fairly straightforward. But the emergence of new information technologies during the late 1980s and 1990s enabled many enterprising entrepreneurs, such as Jeff Bezos, the founder and CEO of Amazon, to come up with new business models that radically changed how firms created value within an industry. And the increasingly global nature of business, coupled with new approaches to sharing information and coordinating work, allowed entrepreneurs such as Leo Fernandez, Robin Chase, and Antje Danielson to tweak a business model from one country to suit market needs in another. As we entered the twenty-first century, crafting the business model for a new venture and communicating it to investors in a business plan or pitch became essential skills for over aspiring entrepreneurs—especially those who were creating businesses that would be financed by VC investors.
Crafting a Business Model for a New Venture

Although we present the process of crafting the business model for a new venture in a linear fashion, it is important to keep in mind that it is highly iterative. This process helps the founding team members frame the decisions that must be made as they design and launch their business and provides an opportunity to debate the assumptions on which the venture is based. Finally, entrepreneurs use the discussion of the business model to identify and clarify the assumptions that drive revenues and costs as they forecast cash flow and design experiments to test the validity of their business models. Learn how to design experiments and refine a business model in *Core Reading: Experimenting in the Entrepreneurial Venture* (HBP No. 8077).

As mentioned earlier, crafting a business model for a new venture involves three interrelated sets of decisions:

1. Defining a unique strategy that differentiates the new venture from the alternatives
2. Identifying the resources and capabilities required to execute the strategy
3. Identifying the compelling benefits and value proposition for key stakeholders (including cash flow forecasts, a crucial piece of information for investors)

We’ll consider each of these in turn, suggesting well-known and widely taught tools and frameworks that can help with each step and examining the decisions made by the entrepreneurs we’ve been discussing.

Defining a Unique Strategy

A business model requires a series of choices; so does a strategy. These choices include decisions about (1) the industry or industries within which the venture will compete; (2) the markets to serve, the specific needs that will be met, and the timing for entering each market; (3) the products, services, and solutions that will be sold and the timing for rollout; (4) the price of these offerings and how they will be differentiated from the alternatives; and (5) the key stakeholders that make up the new venture’s business network (or business *ecosystem*), the role that the new venture will play in the ecosystem, and the roles that customers, suppliers, partners, and other members of the ecosystem will play. Strategy expert Michael Porter stresses that developing a competitive strategy “is about being different. It is about deliberately choosing a differentiated position and a set of activities that enable you to deliver unique value.” Successful strategies, he explains, define how a company plans to identify and achieve a position that “woos customers from established players or draws new customers into the market.”

An entrepreneur can think of strategy decisions as falling into three broad areas: the overall context and size of the opportunity, the *product-market positioning* at entry and how this will change as the business grows, and the ecosystem of customers, suppliers, partners, investors, and advisers that the venture will need in order to develop its offerings and take them to market. *Exhibit 3* provides an approach for crafting a new venture’s strategy.
## EXHIBIT 3  Crafting a New Venture Strategy

<table>
<thead>
<tr>
<th>Assessment Area</th>
<th>Analysis</th>
<th>Sample Frameworks</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Context</strong></td>
<td>Identify industry or industries, current players, power, and positioning</td>
<td>Porter’s Five Forces analysis considers customer power, supplier power, competitive rivalry, threat of substitutes, threat of new entrants.</td>
</tr>
<tr>
<td></td>
<td>Identify key trends—including demographic, economic, political, regulatory, and societal factors—that influence or could influence the success of your new venture, both positively and negatively</td>
<td>PESTLE analysis considers political, economic, sociocultural, technological, legal, and environmental factors.</td>
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<tr>
<td></td>
<td>Don’t just look at what’s happening now—look at what’s changing</td>
<td></td>
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<tr>
<td></td>
<td>Ask, “Is the wind at my back—or in my face?” And, more important, “Will the winds shift in the future and, if so, when do I expect the shift?”</td>
<td></td>
</tr>
<tr>
<td><strong>Product-market positioning</strong></td>
<td>Identify markets, customer segments, and early adopter target customers you will serve at product launch and how to acquire and retain them</td>
<td>Five C’s analysis considers customer need, company capabilities, competition, collaborators, and context.</td>
</tr>
<tr>
<td></td>
<td>Identify the size of the overall market today—not just initial customers but the potential revenue if you had 100% of the market</td>
<td></td>
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<tr>
<td></td>
<td>Determine whether the market is growing, holding steady, or declining, and the rate at which you expect it to change over the next one, three, and five years</td>
<td></td>
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<tr>
<td></td>
<td>Identify pressing problems customers face or compelling opportunities they could pursue and what customers are able and willing to pay</td>
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<td></td>
<td>Identify potential users and decision makers; are they the same and, if not, what motivates each group?</td>
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<tr>
<td></td>
<td>Evaluate entry product and service offerings as “solutions” to customers’ pressing problems and compelling opportunities</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Compare your offerings with alternatives presented by competitors or substitutes; identify what makes yours different in ways that matter to customers and how easy or hard it is (or will be) for customers to understand the value of your offerings relative to alternatives</td>
<td></td>
</tr>
<tr>
<td><strong>Business network or ecosystem</strong></td>
<td>Identify the core activities needed to design, develop, produce, distribute, market, sell, and service products or solutions delivered to end users</td>
<td>Value chain analysis considers primary activities (inbound logistics, production, outbound logistics, marketing, sales, service) and support activities (infrastructure, finance, human resources management, procurement, Information Technology).</td>
</tr>
<tr>
<td></td>
<td>Define activities you will perform and those to be performed by others</td>
<td>VRIO analysis considers value, rarity, imitability (how easily an offering can be copied), and organization (whether capabilities can be built and efficiently organized).</td>
</tr>
<tr>
<td></td>
<td>Draw your business network (ecosystem), identifying key players (e.g., suppliers, channel parties, logistics players, partners) and the relationships among them, including flow of products or services, the flow of information, and the flow of money</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Highlight players that have tremendous power because of proprietary assets or scarce resources that they control, unique capabilities that they have, products and services they provide, or value they have created and/or claimed</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Compare the quality and cost of performing activities and providing products and services internally and externally</td>
<td></td>
</tr>
</tbody>
</table>

Source: Adapted and reprinted from Harvard Business School, “Crafting Business Models,” HBS No. 808-705, by Lynda M. Applegate. Copyright © 2008 by the President and Fellows of Harvard College; all rights reserved.

In defining a strategic position, entrepreneurs must consider not only the launch of the venture but also how that position might evolve as the new venture grows. The choices for evolving a strategy beyond the market entry position can be treated as “strategic growth options.” There are key three categories of growth options an entrepreneur can consider. (Note: Although it is not a growth option, entrepreneurs should also consider whether to exit an existing product or market.)
1 *Enhance.* Make incremental improvements to an existing product or channel to market

2 *Expand.* Launch new products OR enter new markets

3 *Explore.* Launch new products AND enter new markets (e.g., launch a new business)\(^3^1\)

The product-market matrix in **Interactive Illustration 1**, adapted from Igor Ansoff’s market-diversification matrix, shows how these three approaches can be framed as either incremental or radical shifts in strategy.\(^3^2\) *Enhancements* to current products or channels represent incremental adjustments to an existing strategy. An entrepreneur often chooses this approach as a venture begins to gain traction in a market and transitions to growth. Strategic *expansions* are opportunities to launch a new product in the existing market or to launch the existing product in a new market. The shaded regions on the matrix represent less radical shifts in strategy that enable the entrepreneur to expand into new product categories that are similar to current products or to expand into new markets that are similar to current markets. By expanding into adjacent product categories or markets, the entrepreneur should be able to leverage existing strategic positions and capabilities. As a new product or market moves farther from the current position, the strategic choice becomes more radical, and the ability to leverage current positioning and capabilities becomes more uncertain. In these situations, a more detailed analysis of the effect of the strategic choice on the current business model may be required. Finally, at times an entrepreneur may recognize an opportunity to *explore* a new opportunity by launching a new product in a new market. This kind of radical innovation may involve not only a change to product-market positioning but also entry into a brand-new industry with new competitors, and it may require building a new business ecosystem and crafting a new business model.

Recall Leo Fernandez’s evolution of Telepizza’s strategy. His initial idea was to provide home-delivered pizza (*product positioning*) to families in Spain—especially time-pressed, dual-career families in Spain’s largest cities (*market positioning*). He tested this idea by first opening a pizza delivery store near his home (*entry positioning*). Knowing when he started that he planned to launch throughout Spain and then expand into global markets, he built his business model with this rapid growth in mind. For example, after testing the initial concept by running his first two stores himself, he replicated his single-store business model in similar neighborhoods within the same city (*same product, same market*) while expanding into other Spanish cities with similar demographics (*same product, adjacent market*). As he began to blanket Spain, he began opening Telepizza stores in new international markets, including Portugal and Latin America (*same product, radically new market*). Starting with pizza only, he later added healthy side dishes and salads (*adjacent product*). Finally, Telepizza branched out to launch dine-in, fast-casual restaurants TeleGrill (featuring chicken and ribs specialties) and TeleOriental (offering Chinese, Japanese, and Indian foods) (*new business*). This growth path is depicted in Interactive Illustration 1; click on the Telepizza logo and then click on the orange circle for each step in the process to trace the growth opportunities Leo Fernandez pursued as he expanded Telepizza.
Robin Chase and Antje Danielson also crafted Zipcar’s business model with growth and expansion in mind. The founders’ initial idea was to launch a car-sharing service (entry product positioning) to urban commuters in densely populated US cities (entry market positioning). They began by testing and refining the concept in Boston and then leveraged what they learned in Boston to expand into similar East Coast cities: New York and Washington, D.C. (same product, adjacent market).

It is important to note that both Leo Fernandez and co-founders Chase and Danielson planned for the evolution of their ventures as they crafted the initial business models. By considering potential strategic growth options up front, they were able to develop the infrastructure that would be required to run a large, national business as they rolled out the new venture.

Evan Williams, however, followed a less analytical and more intuitive approach. His initial idea to start a small direct-marketing firm with his girlfriend, brother, and father did not succeed because the team was not able to define a viable product and market position. Given that his primary motivation was to run his own business and that he was not passionate about direct marketing, he quickly abandoned the idea when he saw the World Wide Web, and he decided to launch a business that would develop websites (product positioning) for early adopter individuals and companies that wanted a presence on the web (market positioning). He continued to pursue this idea after moving to Palo Alto, spending time working for O’Reilly Media and becoming a freelance web developer. But it was not until he launched a new business that would sell a suite of web-based project management collaboration tools (product positioning) for web developers working within established firms and emerging web businesses (market positioning) that he crafted his first viable business model. Blogger was intended to be just the first product. But as he searched for a revenue model for Blogger, he received valuable guidance from Dan Bricklin, the inventor of VisiCalc, and was able to sell his initial product to Google. Similarly, the initial concept for Odeo was to develop and deliver audio podcasting content (product positioning) to consumers (market positioning) over the
Identifying Resources and Capabilities

As they identify the activities that must be performed and the roles the venture and its ecosystem partners will play in developing entry products and services, entering entry markets, and delivering these products and services to customers, entrepreneurs are, at a high level, starting to pinpoint the capabilities and resources they need, including: the employees (or other firms) who will perform the activities; the equipment, facilities, and raw materials needed to develop and deliver entry products and services to entry markets; the connections and advisers needed to attract financing and other resources; and the leadership talent required to set direction and execute at launch and as the new venture gains traction. At this stage, it is helpful for entrepreneurs to identify key milestones—such as developing the initial offering, entering and gaining traction in the market, and achieving positive cash flow. The entrepreneur then makes assumptions about the time it will take to achieve each milestone and the required resources and capabilities. Exhibit 4 provides an approach for identifying the capabilities and resources needed to execute strategy. See Core Reading: Attracting Talent and Building Ecosystems (HBP No. 8068) for more on how to secure the resources and talent a new venture needs.
**EXHIBIT 4** Identifying a New Venture’s Capability and Resource Requirements

<table>
<thead>
<tr>
<th>Assessment Area</th>
<th>Analysis</th>
<th>Sample Frameworks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Go-to-market and operating models</td>
<td>• Identify activities needed to design and build the entry product or service&lt;br&gt;• Identify key suppliers and activities needed to procure materials, components, and services&lt;br&gt;• Identify key customers and the activities needed to market, sell, and serve them&lt;br&gt;• Identify how you will coordinate these activities to “reduce friction,” remove bottlenecks, and ensure quality&lt;br&gt;• Identify core operating activities to be performed inside your organization and those that will be sourced from others&lt;br&gt;• Conduct the same analysis of activities needed to support noncore activities (e.g., finance, human resources)&lt;br&gt;• Identify information needed to coordinate and control core operations</td>
<td>Process mapping&lt;br&gt;Workflow modeling</td>
</tr>
<tr>
<td>People and partners, including key roles and leaders</td>
<td>• Identify the talent and expertise needed (internal and external) to perform key activities and the approach for attracting, developing, motivating, assessing, and retaining top talent&lt;br&gt;• Identify advisers and other partners needed to attract talent and expertise&lt;br&gt;• Identify key positions—including leadership and specialized expertise—that must be filled to achieve key milestones</td>
<td>Deming’s system of organizational knowledge&lt;br&gt;Talent management&lt;br&gt;Private company compensation</td>
</tr>
<tr>
<td>Organization alignment and culture</td>
<td>• Group people and partners into work teams that enable them to work together to accomplish the activities needed while protecting and developing expertise. (Note: Most new ventures start as simple, team-based structures that become more complex as the business grows.)&lt;br&gt;• Define coordinating mechanisms (teams, reporting relationships, information systems) that will enable people to coordinate work across team boundaries inside and outside the venture&lt;br&gt;• Identify key decisions and the person who will have the ultimate authority for making each&lt;br&gt;• Identify core values and the processes for communicating them; ensure that people make decisions and take actions that are consistent with them</td>
<td>McKinsey 7S organizational alignment&lt;br&gt;Mintzberg’s organizational configurations&lt;br&gt;Greiner’s “Evolution and Revolution as Organizations Grow”</td>
</tr>
<tr>
<td>Leadership and governance</td>
<td>• Identify key assumptions that drive cash flow forecasts and the metrics and milestones needed to measure progress toward achieving targets&lt;br&gt;• Develop testable hypotheses that underlie cash flow forecasts; design market-based experiments and performance-measurement systems to test the hypotheses&lt;br&gt;• Identify how to determine when to <strong>pivot</strong> and refine your business model or exit</td>
<td>Wasserman’s “founder’s dilemmas”&lt;br&gt;Discovery-driven growth&lt;br&gt;Innovator’s DNA&lt;br&gt;Levers of control</td>
</tr>
</tbody>
</table>

The resources that must be assembled and the capabilities that must be built to enter the market form the platform on which the business can be scaled once it has gained traction with its initial strategic position. Taking time to think through potential growth options while crafting the initial business model helps entrepreneurs ensure that they are building the business not just to succeed in its entry position but also to navigate the tricky transition to growth.
Leo Fernandez learned as he launched and worked in his first pizza store what key activities the store manager, service workers, and delivery people would need to perform. In addition, he formed relationships with key suppliers and customers and learned about their interests and their expectations about their relationship with Telepizza. He used this knowledge and his experience working for leading consumer products companies to design state-of-the-art marketing, sales, operations, human resources management, and control systems, and he established the high-performance culture that would be required to expand. He then leveraged both his operating platform and his strategic positioning to transition to high growth and scale the Telepizza business throughout Spain.

Robin Chase launched the first Zipcar service in the Boston area, where she lived, so that she could prototype the local service delivery model while designing the corporate organization and operating model that rapid growth would require. By separating the capabilities and resources needed to offer the car-sharing service to customers from the back-office functions and activities and the corporate leadership and governance systems, Chase and Danielson were able to build a scalable business that could be replicated in other cities. The initial business model broke out the variable costs per car for delivering the Zipcar service and the overhead costs of local offices and corporate headquarters. Leo Fernandez used the same approach. This enabled the Zipcar and Telepizza founders to identify the cash flow needs of their respective businesses—not just at entry but also as it transitioned to growth.

As discussed above, the strategic positioning choices involved in crafting a business model enable an entrepreneur to identify assumptions about the revenue the business will generate. Similarly, choices regarding resources and capabilities, when they are needed, and how they can be leveraged reveal the cost of generating that revenue. As we will see, these assumptions become an important input into the development of cash flow forecasts.

### Defining Value Created for Stakeholders

Crafting the **value proposition** for key stakeholders of the venture involves identifying the benefits that will be created and how those benefits will enable the entrepreneur to attract the stakeholders needed to launch and expand a successful business. It is helpful to begin by returning to the choices the founders made as they defined a unique strategy (see Exhibit 3) and identified the resources and capabilities required to execute the strategy (see Exhibit 4). These choices helped them identify key internal stakeholders, such as founding team members, key employees and advisers, and key external stakeholders, such as customers, suppliers, partners, and investors (shareholders).

After identifying these stakeholder groups, entrepreneurs can assess their interests and expectations, the value that each group will provide, and the value each will require in return for helping to achieve key milestones. In defining stakeholder value, it is helpful to think about tangible and intangible benefits. **Exhibit 5** provides an approach for identifying key stakeholders and the value that the new venture will provide.
EXHIBIT 5 Identifying the Value Created for Key Stakeholders

<table>
<thead>
<tr>
<th>Assessment Area</th>
<th>Analysis</th>
<th>Sample Frameworks</th>
</tr>
</thead>
</table>
| Stakeholder identification and analysis| • Identify key internal and external stakeholders that will be critical for achieving key milestones (e.g., entering the market, achieving traction, and transitioning to growth)  
• Map the stakeholders on a matrix on the basis of their importance to achieving a given milestone and their expectations of value they will receive in return for their contributions | Stakeholder mapping                     |
| Stakeholder benefits and value proposition | • Identify key customers and the tangible and intangible benefits (e.g., the value proposition) that the venture will deliver to them, taking into account customers’ direct and indirect costs  
• Identify key employees and partners and conduct a similar benefit analysis  
• Identify financing needs and expected value and returns for key stakeholders | Customer lifetime value  
Service-profit chain  
Entrepreneurial finance and valuation tools |
| Cash flow forecast and scenario testing | • Identify key revenue and cost drivers; forecast cash flow  
• Identify the key assumptions used to create best-case cash flow forecasts and conduct scenario testing by defining best-case and worst-case assumptions and analyzing the effect of changes in assumptions on cash flow  
• Identify performance metrics that will be used to analyze progress as the business is launched and tested in the marketplace | Cash flow analysis  
Scenario testing  
Fishbone analysis |

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Developing Cash Flow Forecasts

The power of business model thinking does not come from collecting and analyzing independent buckets of data that are the result of business model choices. Instead, it comes from stepping back to consider the assumptions on which those choices are based. Founders use these assumptions to develop revenue and cost forecasts, which in turn are used to model cash flow forecasts. They then use the cash flow forecasts and the assumptions behind them to calculate a set of metrics that they believe will enable them to identify whether their product-market positioning and resource decisions accurately reflect the cash flow that will be generated once the service is launched. For example, cash flow metrics for a grocery co-op launch are presented in Exhibit 6, using a tool called a fishbone diagram. Developed in the 1960s by Kaoru Ishikawa, a pioneer in the field of quality management, fishbone diagrams (also called cause-and-effect diagrams) were initially used to model important metrics that drove product quality and efficiency as industrial-age firms sought to implement “lean manufacturing.” They have been adapted to help founders design experiments to test the relationship between business model assumptions and cash flow forecasts.

Using this tool, founders review their cash flow forecasts for their initial business plan and the assumptions underlying them. Then they review actual results and identify insights that they gain from comparing the cash flow forecast assumptions to actual business results. As you can see, the founders of the grocery co-op decided that the key cash flow metric they would track was operating margin. The key revenue drivers for this metric were the number of customer checkouts and the average total sale per checkout. The key cost drivers were broken down into fixed and variable costs. Membership revenues were also tracked, along with their assumptions about the drivers of membership revenues. Supplemental Reading 3.2 provides...
another example of how entrepreneurs can "stress-test" the assumptions they are making when constructing cash flow forecasts by comparing different business models.

EXHIBIT 6 Grocery Co-op Fishbone Analysis

2.4 Conclusion

In the book *Heart, Smarts, Guts, and Luck*, experienced entrepreneur and venture investor Tony Tjan and his co-authors describe what all successful entrepreneurial teams possess as a combination of "heart" (passion and motivation), "smarts" (analytic and creative-thinking skills), "guts" (intuition based on education and experience, as well as the courage to take action), and "luck" (being in the right place at the right time). The founders we have studied in this reading demonstrate those qualities, but their stories also show that different entrepreneurs draw on different combinations of those qualities as they recognize and shape opportunities.

Leo Fernandez drew mostly on the intuition and smarts he had honed during his decades of business experience and on his desire for independence. Antje Danielson drew on her years of research on energy sustainability to provide the creative spark for Zipcar’s car-sharing service. Robin Chase brought strong analytical skills—honed while earning an MBA and working as a strategy consultant—to the design and refinement of Zipcar’s business model. In founding Blogger and then Twitter, Evan Williams drew on a combination of smarts, experience gained from several false starts, and luck.

In closing, consider Tjan’s helpful guidance to entrepreneurs as they begin their entrepreneurial journeys:

Figuring out which traits [heart, smarts, guts, and luck] drive you and your decisions is the most important thing you can do to enhance your business leadership. Greater awareness of what you’re best at, and how and when you might need to turn up or turn down the volume of the other traits, is what separates the best business-builders from those who are very good. From an organizational perspective, knowing your own [qualities] allows you to better understand what kind of people best complement you during specific points of the business-building growth cycle—and, equally important—what type of person you might need to supplement (almost everyone needs a kindred spirit) or even succeed you.
3 SUPPLEMENTAL READING

3.1 Designing an Entrepreneurial Apprenticeship

In the past, entrepreneurs were forced to stumble through the early stages of their entrepreneurial careers mostly on their own, but people considering entrepreneurship today have many more resources to draw on. Many universities offer courses that help students determine whether entrepreneurship is the right path for them. Business incubators and accelerators offer workspace, mentoring, networking opportunities, and often some seed capital to entrepreneurs interested in building high-growth businesses. By piecing together various resources and pursuing a range of experiences, aspiring entrepreneurs can design an “apprenticeship” that can help them navigate their personal entrepreneurial journey. Exhibit 7 provides elements of such an apprenticeship and suggestions that those contemplating an entrepreneurial career may want to consider.

**EXHIBIT 7** Designing an Entrepreneurial Apprenticeship

<table>
<thead>
<tr>
<th>Understanding Entrepreneurial Goals and Motivations</th>
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<tbody>
<tr>
<td><strong>What do I need to learn?</strong></td>
</tr>
<tr>
<td>• Do I want to be an entrepreneur?</td>
</tr>
<tr>
<td>• What type of venture do I want to build?</td>
</tr>
<tr>
<td>• When should I get started?</td>
</tr>
<tr>
<td><strong>How do I learn it?</strong></td>
</tr>
<tr>
<td>Entrepreneurs who were exposed to successful entrepreneurs as children may know whether they want to be an entrepreneur early in their careers. Others reach the conclusion much later in life. To find out more about entrepreneurial careers and the types of ventures entrepreneurs build,</td>
</tr>
<tr>
<td>• Work in one or more entrepreneurial startups or shadow entrepreneurs</td>
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<tr>
<td>• Talk with entrepreneurs about their lives and careers; read biographies and autobiographies of famous entrepreneurs; and actively participate in entrepreneurship portals and blogs, such as Entrepreneur.com (<a href="http://www.entrepreneur.com">www.entrepreneur.com</a>)</td>
</tr>
<tr>
<td>• Take classes; attend boot camps; visit incubators and accelerators; and join clubs and associations that draw other entrepreneurs, such as Venture for America (<a href="http://ventureforamerica.org">http://ventureforamerica.org</a>). As your venture grows, join entrepreneurship associations, such as the Young Presidents’ Organization (<a href="http://www.ypo.org">http://www.ypo.org</a>) and the Women Presidents’ Organization (<a href="http://womenpresidentsorg.com">http://womenpresidentsorg.com</a>)</td>
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</table>

<table>
<thead>
<tr>
<th>Recognizing and Shaping Opportunities</th>
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<tbody>
<tr>
<td><strong>What do I need to learn?</strong></td>
</tr>
<tr>
<td>• How do I find the idea for a new venture?</td>
</tr>
<tr>
<td>• How do I prioritize opportunities and choose which opportunity to pursue?</td>
</tr>
<tr>
<td>• How do I analyze the business model of a new venture at the time of entry and as the business grows?</td>
</tr>
<tr>
<td><strong>How do I learn it?</strong></td>
</tr>
<tr>
<td>Founders of successful high-growth, high-impact ventures need to be able to identify those who can help them refine the business model before and during market entry. These business-model analysis skills include:</td>
</tr>
<tr>
<td>• Identifying a compelling opportunity and then identifying a specific product-market entry position</td>
</tr>
<tr>
<td>• Identifying the capabilities and resources needed to achieve an entry position and transition to growth</td>
</tr>
<tr>
<td>• Developing cash flow forecasts, conducting scenario tests, and defining market-based experiments that can be used to test hypotheses</td>
</tr>
</tbody>
</table>
EXHIBIT 7  Designing an Entrepreneurial Apprenticeship (continued)

Assembling Resources and Building a Founding Team

What do I need to learn?

• What expertise, skills, and experience do I have today and what will be needed to found my business, enter the market, and begin to gain traction?
• Whom do I know or need to know who can connect me with the people and resources that I need to launch and build my new venture?

How do I learn it?

It’s helpful to begin forming the network you will need to launch your entrepreneurial career before you need it. Some aspiring entrepreneurs develop important contacts while attending school, including classmates, professors, guest speakers, and so on. Others find important contacts at work, by joining clubs and associations, or by becoming involved in their communities. To find out more about assembling resources and building a team:

• Learn to reach out to people who could become important to your entrepreneurial career with offers of assistance or by proposing common projects
• Realistically assess your own expertise, skills, and experience and identify ways to fill in the gaps in what you will need to launch your entrepreneurial career and venture
• Recognize that it’s easier to approach people who are just like you but resist the urge and begin to approach people with varied perspectives and experiences when assembling your founding team
• Remember to use your “discovery skills” to observe, ask questions, and find patterns in what you are learning

Note: Always check the credentials of clubs and associations found online. See, for example, http://usatoday30.usatoday.com/tech/news/2009-04-19-bizdomu-teaches-entrepreneurship_N.htm. Learn more at http://www.entrepreneur.com/article/217816#ixzz2gxfKt8K1

3.2 Comparing Business Models

The case and interactive exercise in this Supplemental Reading enable you to compare three business models being considered by the senior executive team at SalesLogic. While the company and the names of all executives and other companies in the case are disguised, this exercise is based on real issues that were faced by executives as they attempted to compare business models that could be used to frame the re-launch of a small consulting company. The identifying information has been disguised in a way that captures the issues that the executives faced and the decisions they made. The purposes of the exercise are to:

• Highlight the decisions entrepreneurs make as they identify and shape opportunities and the business model implications of those decisions
• Illustrate how changes in the environment make possible new opportunities that require changes to a business model
• Examine how business model choices are framed as assumptions that are linked to cash flow forecasts and how changes in those assumptions influence risk and uncertainty when launching a new venture

Study Questions

1. Read the SalesLogic case. It is suggested that you print out the case and these study questions so that you can refer to them as you do the interactive exercise at the end of the case.
Why is Jason Schwartz, the CEO of SalesLogic, considering a change to the company’s business model? What are the pros and cons of the three business models he is considering?

Use the SalesLogic interactive illustration to analyze cash flow forecasts for the three business models that Schwartz and his executive team are considering. Do you agree with the assumptions that Schwartz and the SalesLogic executives are making? Which assumptions affect cash flow the most in the short-term? Which assumptions have the most influence on the ongoing economics of the business? Are there other assumptions concerning key revenue and cost drivers that have not been considered in constructing the cash flow forecasts?

What advice would you give to Jason Schwartz and the SalesLogic executives in January 2007 regarding the business model to choose and the assumptions that should be made in constructing cash flow forecasts for 2007 to 2009?

SalesLogic Case

Patrick Hunnewell founded SalesLogic—a custom analytic consulting firm—in 1984 because he wanted to do the work he loved but did not want to manage large teams of people in a big firm. Following graduation with a degree in mathematics and engineering, Hunnewell joined the team at Raytheon that developed the Apollo space program navigation system. Mark Caspar, a fellow scientist at Raytheon who joined SalesLogic shortly after the company was formed and remained the only other full-time employee through 2002, explained: “Patrick was a rocket scientist whose experiences at Raytheon were depicted in the movie Apollo 13. His work on the navigation system contributed to the space ship’s safe return to earth.” Hunnewell’s success earned him a promotion to systems vice president, but the promotion also forced him to shift from doing the mathematics and engineering work he loved to managing a team of 150 programmers. “Every day there was a new personnel crisis to deal with,” he said. “One day one of our top programmers at the company simply stopped coming to work. After that incident, I decided to find something else to do.”

Hunnewell sought advice from college friends who worked on Wall Street as he planned his next career step. He learned that new point-of-sales systems were generating lots of new information for retailers—information that they were not prepared to analyze. Hunnewell joined forces with a few retailers his friends knew and soon learned that demand forecasting and markdowns were key sources of problems. “As we looked at retailers’ financial statements,” Hunnewell recalled, “it was clear that markdowns alone had a huge impact on demand forecasting and the retailer’s bottom line. On average, markdowns cut gross margins from 50% to 33% of sales. . . . I knew we possessed a unique capability that was in demand by retailers. Not only did we have the ‘mental horsepower’ to unravel the data, but we enjoyed this sort of complex problem solving.”

By the late 1990s, SalesLogic was providing custom analytical modeling for major US retailers that specialized in “short-lifecycle merchandise,” including fashion and consumer electronics. Hunnewell and Caspar had hired several local university faculty—all PhD mathematicians—to work with them on a contract basis to develop highly customized analytic models that enabled clients to use information to make decisions. Once a project was sold, it involved a large, up-front investment of the scientists’ time to...
understand the data and build a model. From then on, the retail client would send SalesLogic its weekly data, which was loaded and analyzed on SalesLogic computers; two weeks later, a paper report would be sent by mail to the company. The charge for this custom consulting service was $100,000 to $250,000 to develop the initial model and then 5% of the development fee per month to analyze weekly data and deliver custom reports.

As the retail industry recovered from the economic slowdown of 2000 to 2003, SalesLogic’s clients began asking to license the completed analytical models so that they could be run in-house. Lacking the expertise to evolve from a consulting and statistical modeling firm to a software company, Hunnewell asked Jason Schwartz, his son’s college friend and a retail account executive at IBM, to join the company—initially as vice president of sales. Schwartz explained: “In my first week, I asked Patrick if he had any sales leads, and he opened up the drawer of his desk and pulled out a stack of reply cards from an ad that the company had run a few months before. The first one I picked out was from the director of merchandising at Sears. I kidded Patrick—‘Tell me again why no one bothered to follow up on this lead?’”

By the fall of 2005, Schwartz had built a small marketing team, explored new software product business models, and hired a sales team and some experienced software developers to work with the mathematicians. In addition, Schwartz had become the president and CEO, and Hunnewell had transitioned to chairman.

After a particularly tough client project, Schwartz and the new senior team became convinced that the company needed to move more quickly to change its business model and that the company would need to raise outside financing to make the change.

We had twelve weeks to unravel a terabyte of our client’s data and build a custom application. It took eleven weeks just to extract the data and get it running on our Oracle database. In the 12th week, we “cracked the code” and delivered a demand forecasting model that wowed them. When they asked us if we could host the application online so that they could access the information through a proprietary website, we tried but we really stumbled. I realized that we needed to develop more standardized, reusable models if we wanted to grow the company, and that would require more capital.

In June 2005, Schwartz successfully raised $2 million in equity financing from a small technology VC firm at a post-money valuation of $12 million. At the same time, Schwartz and several members of the SalesLogic senior management team invested an additional $1 million to buy out Hunnewell’s equity stake in the company. The financing was used to hire the talent to build the first custom analytical model that could be hosted on SalesLogic’s computer servers and deliver reports online to a client using a software delivery model that was becoming known in the technology industry as “Software as a Service” (SaaS).

Technically, the term SaaS referred to a “way of delivering software applications over the Internet as a service.” Instead of paying a large licensing fee and an initial configuration fee, plus a small monthly maintenance fee, companies would pay an initial configuration fee plus a larger service fee each month. In 2006, Forrester Research predicted that the SaaS market would grow at a 33% rate year-over-year between 2006 and 2013. Large enterprise software firms, such as IBM, Oracle, and SAP, had begun actively investing to build their SaaS capabilities. Schwartz believed that the SaaS delivery model fit the company’s growth trajectory, but he was concerned about the difficulty of implementing it.
Shifting to an SaaS delivery model would confer several benefits. First, the fundamental economics of the SaaS model were attractive to us because we wanted to move away from fixed-price consulting fees to a longer-term, monthly service fee, and our VC investors had made it clear that they valued subscription fees more than consulting fees. Second, I knew that SalesLogic would benefit from aligning its business model with a fast-growing segment of the IT industry that promised to deliver superior economics to customers. But what we did for our customers could only be described as an art. Our PhD scientists didn’t follow a standardized formula when working with clients to develop a model. So I knew that this would be a tough transition for the company.

Indeed, the software development and business analytics expertise required to build predictive analytical models was in short supply in 2005. Further, there were still a number of SalesLogic’s retail customers that expressed concern about privacy and security issues of running software in company-owned data centers that they could access over company-owned networks.

Despite its customers’ reservations, in 2005 SalesLogic convinced one of its customers to work with the firm to build a custom demand forecasting and markdown optimization model that users could access from a simple online reporting tool. The new model quickly generated impressive results; the client reported a 16% increase in gross margin after three months of use and increased inventory turns, from 2.4x to 3.0x.

But though the new analytical model enabled SalesLogic to test the SaaS online hosting and information reporting, it was still custom built. Schwartz and the team knew that the approach would not work if they wanted to roll out the SaaS hosting and reporting model to a large number of retail clients.

In spring 2006, Schwartz pitched a four-year, $17 million SaaS contract to a multibillion-dollar retailer. To finance development of the project, in late May 2006 Schwartz raised a second round of financing—$16 million at a $45 million post-money valuation—from a well-known private equity firm that had recently launched a VC fund to invest in later-stage technology companies (see Exhibit 8 for the financing history). At the time of the investment, the Series B investors had forecast that SalesLogic would

**EXHIBIT 8** SalesLogic Financing History and Equity Ownership Percentages

<table>
<thead>
<tr>
<th>SERIES A</th>
<th>TechVC #1 (June 2005)</th>
<th>Equity Share</th>
<th>Pre-Money</th>
<th>Investment</th>
<th>Post-Money</th>
</tr>
</thead>
<tbody>
<tr>
<td>Team</td>
<td>83%</td>
<td></td>
<td>$10 Million</td>
<td>$2 Million</td>
<td>$12 Million</td>
</tr>
<tr>
<td>A Investors</td>
<td>17%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>B Investors</td>
<td>—</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>SERIES B</th>
<th>PE/VC #2 (May 2006)</th>
<th>Equity Share</th>
<th>Pre-Money</th>
<th>Investment</th>
<th>Post-Money</th>
</tr>
</thead>
<tbody>
<tr>
<td>Team</td>
<td>54%</td>
<td></td>
<td>$29 Million</td>
<td>$16 Million</td>
<td>$45 Million</td>
</tr>
<tr>
<td>A Investors</td>
<td>10%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>B Investors</td>
<td>36%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Series B investor assumptions:**

- $25M in revenue by December 2009
- 10X multiple of revenue ($250 million valuation) on sale to established enterprise software firm (e.g., IBM, Oracle, SAP) in late 2009
- No new financing
- 54% of $250M to Team at time of sale = $135M
- 36% of $250M to Series B investors at the time of sale = $90M
- 10% of $250M to Series A investors at the time of sale = $25M
grow to $25 million in revenue by late 2009 and that the company could be sold at that
time for $250 million or more to an enterprise software firm, such as IBM, Oracle, or
SAP. The money raised would be used to build a new demand forecasting and
markdown optimization application that would provide both a standardized back-end
analytical model and a standardized user reporting tool that would run on SalesLogic
servers, allowing users to generate different on-demand reports.

To develop the new standardized SaaS application, SalesLogic hired over 30 software
developers, and the company’s "burn rate" rose to $1 million per month between May
and December 2006. During that time, the new SaaS application was built for the
company’s new retail customer and, by late fall, the customer had begun to use the
hosted application. But the new application was less scalable than originally envisioned.
“ I assumed the new application would be reusable,” Schwartz explained. “Instead, we
found ourselves tweaking the model on an almost weekly basis once it went live with our
customer. In retrospect, I realized we had sold them yet another custom analytical model
hosted on our Internet server and that our Series B investor assumptions about our
revenues by 2009 were wrong. In addition, our customers continued to pressure us to
develop a packaged software product that they could license from us.”

In January 2007, with only $9 million in cash remaining, the SalesLogic senior team
revised its forecasts and compared three different business models that it could pursue.
Interactive Illustration 2 compares the revenue and cost implications of the three
options. (Note: The cash flow assumptions for the three options that are reflected in the
interactive exhibit represent cash flow assumptions for the potential new businesses that
SalesLogic is considering and do not reflect ongoing costs of delivering SalesLogic’s
existing services to existing clients.)

**Option 1: Licensed software.** To pursue this option, SalesLogic would create a
packaged software product that could be licensed to retail customers and run within the
customer data centers. It would require a rewrite of the existing demand forecasting and
markdown optimization custom analytic model to create a standardized analytical model
with a standardized user interface and reporting tools. The company estimated it would
need to hire experienced software developers who could work with the company’s
mathematicians to build the standardized analytical model and the user interface and
reporting system. Because the software would run in a customer’s data center, the
company estimated it would also need to build a professional services group to handle
system integration at each customer site and would need to hire additional quality-
assurance engineers to test the software before its release. Finally, the company would
need to hire experienced salespeople to sell the packaged software through enterprise
software channels. Given these assumptions, Schwartz and the executive team estimated
that the company would need to spend $1 million per month between January 2007 and
December 2007 to launch the new licensed software business model. At this burn rate,
the company would need to raise additional financing in early summer 2007. Once the
new offering was implemented, the company estimated it would begin generating
revenue from new customers in January 2008, and it would add one new customer per
month during 2008 and two new customers per month during 2009. It was estimated
that onetime revenue per client at the time of sale would be $2,200,000 ($1,000,000 initial
configuration fee plus $1,200,000 for a onetime licensing fee). The initial cost to sell and
configure a new client system within the customer’s data center would be approximately
$1,700,000. Thus, the gross margin for selling a new licensed software package would be
$500,000. Ongoing revenue per client per month would be $15,000 (maintenance fee),
and the monthly cost of servicing an established client would be $7,500, yielding a
monthly gross margin for an established client of $7,500.
Option 2: SaaS business model with standardized back-end. This option would involve building the same standardized back-end analytical model and front-end interface that would be required if the company pursued option 1. Because the application would run on SalesLogic’s internal servers, however, there would be no need to perform quality-assurance testing before the release of the software. In addition, because no on-site customer system integration would be required, the company would not need to build a system-integration team and, instead, would need only a smaller professional services group to train users at the client site. In addition, the company could leverage existing salespeople to sell the new standardized SaaS application. The company estimated that these savings would enable the company to reduce its burn rate to $750,000 per month and to complete the development between January 2007 and October 2007. At this burn rate, the company would have a small amount of cash remaining at the end of 2007. The company estimated it would begin to generate revenues from customers after implementation, beginning in January 2008. It expected to sell to one new client per month during 2008 and two new clients per month during 2009. In addition, the company estimated that onetime revenue for each new client would be $1,000,000 (initial configuration fee), and the cost to sell and configure a new client’s SaaS application on SalesLogic’s servers and to train users would be approximately $800,000. The gross margin for a new SaaS client would therefore be $200,000. Ongoing revenue per client per month would be $100,000 (monthly service fee), and the cost of servicing that client would be $25,000, yielding a gross margin of $75,000 per client per month.

Option 3: Custom consulting model. This option would involve continuing to provide custom consulting services, but the analytical models developed for each customer would be hosted on SalesLogic’s servers. The company estimated that it could reduce its burn rate to $500,000 per month between January 2007 and December 2007 while it continued its implementation of the custom analytics software for the five existing clients. The company estimated that it would be able to add one new client every four months in 2008 and one new client every other month in 2009. Finally, the company estimated that onetime revenue per client at the time of sale would be $1,500,000 (initial configuration fee), and the cost to sell and create a custom analytical model would be approximately $1,200,000. Thus, the gross margin for selling a new custom software solution would be $300,000. Ongoing revenue per client per month would be $100,000 (monthly service fee), and the cost of servicing that client would be $50,000, yielding a gross margin of $50,000 per client per month.

The assumptions for the three options, seen in Exhibit 9, represent the cash flow assumptions for the potential new businesses that SalesLogic could launch and do not reflect ongoing costs of delivering SalesLogic’s existing services to existing clients. Interactive Illustration 2 enables you to compare the revenue and cost implications of the three options.
EXHIBIT 9  Business Model Assumptions

NEW PRODUCT DEVELOPMENT COSTS (“BURN RATE”)
(Recall that SalesLogic had $9 million in cash remaining at the end of 2006.)

Licensed Software: $1 million per month (January 2007–December 2007) = $12 million
Standardized SaaS: $750,000 per month (January 2007–October 2007) = $7.5 million
Custom consulting: $500,000 per month (January 2007–December 2007) = $6 million

<table>
<thead>
<tr>
<th>PER CUSTOMER ECONOMICS</th>
<th>Licensed Software</th>
<th>Revenue/Client</th>
<th>Cost/Client</th>
<th>Gross Profit/Client</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial configuration fee</td>
<td>$1,000,000</td>
<td>$1,700,000</td>
<td>$(700,000)</td>
<td></td>
</tr>
<tr>
<td>Onetime license fee</td>
<td>1,200,000</td>
<td>0</td>
<td>1,200,000</td>
<td></td>
</tr>
<tr>
<td>Economics for a new client (1 new client per month during 2008) (2 new clients per month during 2009)</td>
<td>2,200,000</td>
<td>1,700,000</td>
<td>500,000</td>
<td></td>
</tr>
<tr>
<td>Monthly maintenance fee (existing clients)</td>
<td>15,000</td>
<td>7,500</td>
<td>7,500</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>PER CUSTOMER ECONOMICS</th>
<th>Standardized SaaS</th>
<th>Revenue/Client</th>
<th>Cost/Client</th>
<th>Gross Profit/Client</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial configuration fee</td>
<td>$1,000,000</td>
<td>$800,000</td>
<td>$200,000</td>
<td></td>
</tr>
<tr>
<td>Economics for a new client (1 new client per month during 2008) (2 new clients per month during 2009)</td>
<td>1,000,000</td>
<td>800,000</td>
<td>200,000</td>
<td></td>
</tr>
<tr>
<td>Monthly service fee (existing clients)</td>
<td>100,000</td>
<td>25,000</td>
<td>75,000</td>
<td></td>
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</table>

<table>
<thead>
<tr>
<th>PER CUSTOMER ECONOMICS</th>
<th>Custom Consulting</th>
<th>Revenue/Client</th>
<th>Cost/Client</th>
<th>Gross Profit/Client</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial configuration fee</td>
<td>$1,500,000</td>
<td>$1,200,000</td>
<td>$300,000</td>
<td></td>
</tr>
<tr>
<td>Economics for a single new client (1 new client every 4 months during 2008) (1 new client every other month during 2009)</td>
<td>1,500,000</td>
<td>1,200,000</td>
<td>300,000</td>
<td></td>
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<tr>
<td>Monthly service fee (existing clients)</td>
<td>100,000</td>
<td>50,000</td>
<td>50,000</td>
<td></td>
</tr>
</tbody>
</table>

Once you have examined the assumptions for each of the possible business models, use Interactive Illustration 2 to identify changes that you would make to key assumptions, and that Schwartz and the executive team should make based on your analysis of each business model. Before beginning the exercise, remember to print out the SalesLogic case and the instructions for using the interactive illustration. These instructions will also be available when you click on the interactive illustration. Click on “X” to close the instructions and on the “i” in the left hand corner to open them.

Instructions for Completing the SalesLogic Business Model Comparison

While you are using this interactive graphic, you can:

- Restore the default instructions for any model and start over by clicking on “restore default instructions” at the top left corner of the cash flow graphic
- Download an Excel workbook by clicking on “link to workbook”
- Show a cash flow forecast table by clicking on “show table”
Answer the following questions:

1. Examine the cash flow characteristics of each business model. Which has superior economics on a per-customer basis? Which business model has superior economics as a business opportunity for SalesLogic’s founders and investors?

2. For each of the three proposed business models, test the sensitivity of the SalesLogic cash flow forecast to changes in revenue assumptions.

3. Test the sensitivity of the SalesLogic cash flow forecast for each of the three proposed business models to changes in the burn rate during 2007 and to changes in the cost to add a new client during 2008 and 2009. Before you change the new client costs, be sure to consider which costs you think need to be added or subtracted and the reason you are making these changes. For example, you may decide that the baseline cost assumptions are too high because SalesLogic can add fewer salespeople or decrease its marketing expenses. Or, you may decide that the baseline cost assumptions are too low because they need more salespeople and should increase marketing spend.

4. Once you have changed all of the models to reflect your new assumptions for the business, return to the graphical comparison of all three business models to identify how these changes in assumptions affect the attractiveness of each business model.

5. What advice would you give to Jason Schwartz regarding which business model to choose and the assumptions that should be made in constructing cash flow forecasts for 2007 to 2009?
4 KEY TERMS

**analytical thinking** A rational problem-solving approach that involves breaking a problem or question down into its components and analyzing them. Useful for shaping an idea into a viable business opportunity.

**business model** The plan for building and operating a venture that identifies a strategy for entering a focused market segment with an entry solution that will attract customers, partners, investors, key employees, and the other resources that will be needed to enter and gain traction in the market and create value for all stakeholders.

**business plan** A written document that lays out how a business will operate. There are several types of business plans; these are defined in more detail in Core Reading: Developing Business Plans and Pitching Opportunities (HBP No. 8062).

**cash flow forecasts** Projections of the financial returns that a business will generate over a certain period.

**discovery skills** Five important skills that entrepreneurs use in launching new ventures and transitioning to growth.

**ecosystem** The network of partners, supporters, customers, and other stakeholders that work together to launch and grow a venture.

**fishbone diagram** A model that identifies factors that drive outcomes. It is called a fishbone because it graphically resembles the skeleton of a fish.

**intuitive (gut) thinking** A creative and associative approach that enables entrepreneurs to find patterns and recognize ideas. Useful for conceiving business ideas.

**pivot** Response to feedback by changing some business model elements while retaining others.

**product-market positioning** A decision about what attributes and features a product will have and how it will be launched in the marketplace (e.g., promotion plan, channels to be used, pricing strategy), given customer needs.

**value proposition** A statement of how the venture’s products or services will meet the needs of potential customers.

5 FOR FURTHER READING


6 ENDNOTES


6 The Telepizza story is adapted from Walter Kuemmerle, Chad Ellis, and Juan Roure, “TelePizza,” HBS No. 899-080 (Boston: Harvard Business School, 1999).


25 This section adapted and reprinted from Harvard Business School, "Crafting Business Models," HBS No. 808-705, by Lynda M. Applegate. Copyright © 2008 by the President and Fellows of Harvard College; all rights reserved.


This case example is based on a real company’s experience. The names of the company, the founders, and the management team have been changed, and the financial information and forecasts have been disguised.


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