# 1

# Translate Your Idea into a Compelling Business Model



EVERY GREAT BUSINESS STARTS with a great idea. You probably wouldn't be reading this book unless you already had at least the glimmerings of a business idea. In this chapter, you'll learn how to take your raw, perhaps unproven idea and measure its likelihood of success—then enhance, improve, and solidify it.

## Elements of the Business Model

A business model is the idea that underlies a successful business. It describes how the business creates value for customers, delivers that value to them, and captures a portion of the value for its owners. Every successful business, no matter how large or small, complex or simple, operates according to a business model that makes sense. (Of course, some large, complex companies operate according to several business models at once since they include divisions or departments that create, deliver, and capture value in varying ways. But don't let that confuse you.) Therefore, one of the most important steps you need to take as an entrepreneur is to transform your business idea into a business model that shows how you'll create, deliver, and capture value.

There are many ways to think about a business model. One of the most effective is described and illustrated by Alexander Osterwalder and Yves Pigneur in their best-selling book *Business Model Generation*.*
In their structure, a business model includes nine basic elements:

- **Customer segments**. The specific, different groups of customers the business serves—that is, the identified customers for whom it will create value.
- **Value propositions**. How the business solves problems and meets the needs of its customers, creating value for them in the process.
- **Channels**. How the business reaches its customers and delivers value to them—for example, through direct online sales, retail distribution channels, value-added resellers, company-owned storefronts, or affiliate programs.
- **Customer relationships**. The ways in which the business connects with, relates to, and retains customers.
- **Revenue streams**. Where the money comes from: how the business generates income from the value propositions it offers to customers.
- **Key resources**. The assets required to create and deliver the value propositions to customers—for example, physical assets such as buildings and machinery, and human assets such as employees with particular skill sets.
- **Key activities**. What the business does to make its business model work, such as inventing, buying, building, distributing, operating, and so forth.
- **Key partnerships**. Outside organizations, such as suppliers and partners, that help the business model work.
- **Cost structure**. The costs that the business incurs in operating its business model.

These nine elements can be mapped in a diagram that Osterwalder and Pigneur call the Business Model Canvas, which provides a standardized, visual way of analyzing, developing, and refining your ideas. You can print out a large-format version of the Business Model Canvas

*Hoboken, NJ John Wiley & Sons, 2010.

and post it on a wall or spread it out on a table so that you and your cofounders can work on it together.

One benefit of the nine-elements model in the canvas is that it forces you to think through all the key pieces that need to be in place to make a business idea into a viable basis for a profitable, self-sustainable company.*

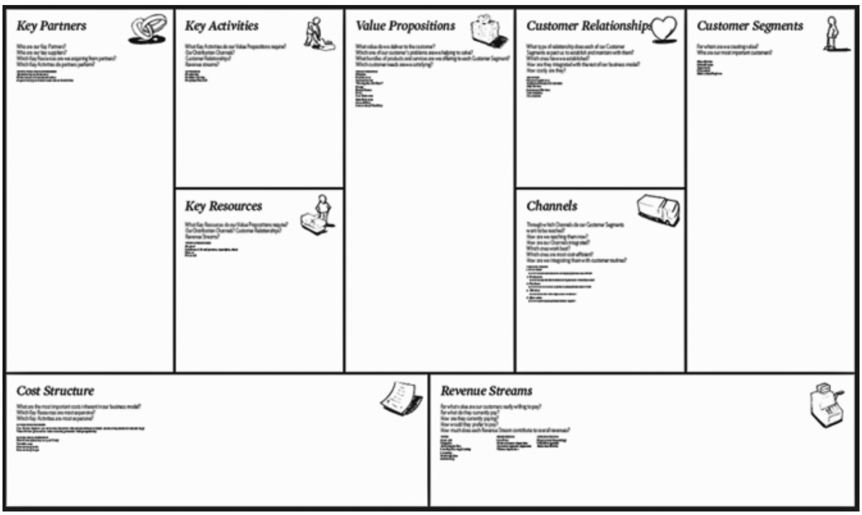


**Figure 1.1** The Business Model Canvas

Copies of printed templates for the Business Model Canvas can be downloaded for free from businessmodelgeneration.com. An online, interactive version of the Canvas specifically designed for high-growth startups is available at LeanMonitor.com. Another comprehensive online version is available at Strategyzer.com.

## The Importance of Understanding Your Business Model

These days, it seems like everyone is a wannabe entrepreneur—just as everyone used to be an aspiring actor or have the Great American Novel in a back pocket. While I have heard many clever ideas

* Another good guide to the process of analyzing and sharpening a business model is *The Startup Owner's Manual* by Steve Blank and Bob Dorf (K & S Ranch, 2012), which walks you through the process of developing and refining the Business Model Canvas within the context of a startup.

for products and services over the years, in my experience, the number one differentiator between an aspirant and a real founder is that the former is in love with his product, but the latter is in love with her business model. I have often had discussions with other investors about companies that have approached us for funding, and we all had the same reaction: "I can't wait to buy the product when it comes out . . . but no way would I invest in the company!" A product or service can be cool, or innovative, or beautiful, or even useful, but it only becomes a viable business if the aggregate economics of the value being created are significantly more than the aggregate economics of the costs of operating the business. If you are aiming for a scalable business, then you're looking further for a viable business that gets better—not worse—as it gets bigger.

How can you determine whether your business idea has the potential to become a multi-billion-dollar unicorn? In general, there is a simple math equation that estimates basic viability by multiplying four factors:

Number of potential purchasers ×

Percentage of capturable market share ×

Absolute dollar amount of each sale ×

Percentage margin of net profit =

**Total potential profit**

The perfect new business idea would be one that would check all four boxes—that is, it would be appropriate for a large number of potential purchasers, be attractive to a high percentage of those possible customers, generate sales with high dollar value, and promise a high profit margin on each sale. To make it truly scalable, you'd want to check a fifth box—the business would need to get even better as it got bigger.

For example, if you were trying to evaluate a concept for a house-cleaning business, it would be great if everyone in the world needed their house cleaned; if you had a way of locking up the entire global market and servicing every house in the world; if everyone would be willing to pay a large amount for this service; and if your cost to clean a house was low, and dropped with every additional customer. I assume you would take that business, right?

Unfortunately, these five propositions turn out not to be true in regard to housecleaning—which explains why no one has yet ascended to the top of the *Forbes* list of the world's richest billionaires by launching an international housecleaning business.

As you might imagine, business concepts that check all the boxes are exceedingly rare. However, when you look at successful businesses, you'll discover that even three out of the five can make for a viable—and even potentially scalable—business.

For example, take the business of sending tourists up for a visit to the International Space Station. There's obviously not a giant market for that, since it can only accommodate one visitor every few years. But it so happens that one of my portfolio companies actually does that. Why? Because the ticket price is around $50 million per person, it has decent margins, and it has 100 percent market share. (It was also a business, believe it or not, that could be started relatively inexpensively, because its customers paid in full, in advance, before the company was required to pay the Russian government for the actual experience.) And while it's not scalable *per se*, the company has leveraged its experience into allied areas, such as zero-gravity airplane flights, astronaut training, and jet fighter missions.

Furthermore, when you do the analysis, it's important to be clear about what the business is actually doing. Let's go back to the idea of a housecleaning business. It would be very problematic to try to grow housecleaning into a truly large business. The logistics of service delivery around the world would make it extremely difficult to eke out a decent profit margin, and the minimal cost of entry by competitors (who need only a van, some tools and supplies, and a few employees to set up a rival cleaning company) means that you would probably never develop a large market share.

But if we're talking about something like Angie's List or HomeAdvisor, the first thing we need to realize is that the business these companies are in is not actually housecleaning. Instead, it is lead generation and/or booking and intermediating payment for house cleaners. Looking at in that way completely changes the equation. Your marketing and service delivery costs are at Internet scale, and therefore low and decreasing the larger you get. On the other hand, the value you are delivering to the people willing to pay for it (the actual house-cleaner) is high relative to their opportunity costs (which means you can extract a decent margin), and because you can target everyone on the Internet, you have a sizable addressable market (even if only the top one percent would be willing to pay to have their houses cleaned).

This is also the case for other apparently small or low-margin businesses, such as urban taxis (Uber), errands (TaskRabbit), cups of coffee (Starbucks prepaid cards), and free radio (Pandora, Spotify, iHeart-Radio, etc.). Once you add the dozens of potential future revenue streams for each of these enterprises based on their existing infrastructure (Uber providing just-in-time delivery services, online music sites selling concert tickets and memorabilia, Starbucks selling music and coffee machines, etc.), these seemingly quixotic businesses become potentially very large profit centers.

One way to develop the right mind-set is to study the business models that have been employed by other company founders—including both successes and failures. Some great companies have been launched by adapting a business model from one industry to another, or by tweaking a familiar and proven model in a way that unleashes a flood of new resources, customer demand, or technological creativity. In certain circumstances, it is possible to create a successful new company by simply altering one of the nine business model elements in the Business Model Canvas as applied by competing businesses in the same market sector—for example, by discovering and applying a new channel for delivering value to customers; by devising a new way of forging intimate, lasting relationships with customers; or by identifying ways of improving the cost structure of the business and thereby making it more profitable.*

## Developing a Scalable Startup Business

The subtitle of this book is *25 Steps to a Scalable, High-Growth Business*, and the word **scalable** is included for a good reason. There are many enterprises that are successful, profitable, and contribute much to society,

* A great place to examine other companies' business models in an easily digestible form is businessmodelgallery.com, which has re-created over 100 well-known models in Business Model Canvas format. Browse through them by industry or type of company to be inspired.

but which would be unrealistic, unprofitable, or at least overly challenging for you to start building as a one-man or one-woman startup on your way to becoming a unicorn.*

If you are reading this book, then you are unlikely to be building a Death Star, opening a barbershop, or offering xylophone master classes in your living room. That's because, while those might be interesting opportunities, for different reasons none of them are scalable.

There are three characteristics that together make a startup business model truly scalable:

1. *You have to be able to start small.*

   Unless you happen to be the long-lost daughter of Emperor Palpatine, the odds are that you do not have enough capital to build your first Death Star, nor will you be able to raise the funds to do so.† The ideal startup is one that can be bootstrapped from its own early revenues—or at least funded from the founder's personal savings account.
2. *Your marginal costs must drop over time so that each additional dollar of revenue costs less than the previous dollar.*

   This is the core of what most people mean when they discuss business scalability. For example, Amazon's Kindle publishing business is scalable because, after the cost to Amazon of selling the first digital copy is taken into account, each additional copy is almost pure profit. In contrast, if you wanted to expand your barbershop, the second shop would cost you almost exactly as much as the first one (for rent, equipment, and barber salaries). Since no business is infinitely scalable (that is, there is no business where all costs drop to absolute zero), an associated consideration is relative scalability, which means that a business needs to be scalable over a longer range than its competitors.††

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* A "unicorn" is a term coined by venture capitalist Aileen Lee, used to describe a company with a market capitalization of over $1 billion.

† In case you are curious, students at Lehigh University worked out that the cost to build the Death Star would be about $8,100,000,000,000,000 ($8.1 quadrillion), which is 13,000 times the world's GDP.

†† For a longer discussion on scalability, see the article by my fellow New York angel investor Christian Mayaud at http://www.sacredcowdung.com/archives/2005/06/what_is_a_scala.html.

3. *Your scalability needs to be built into your business model, rather than relying on any special exogenous factors.*

   Subway, for example, currently has 45,000 sandwich store locations around the world. And it is opening more than six new stores every single day, including weekends! It would not be able to do that if it had to find world-class cordon bleu chefs for each location. Similarly, if your business depends on recruiting a never-ending supply of xylophone virtuosos who are also good teachers, I'm afraid that it is simply not scalable.