Copyright © 2013 John Seiffer

All Rights Reserved

CI encourages you to share this content, however, in doing so, you may not alter its contents.

ctinnovations.com

THE IMPORTANCE OF BUSINESS MODELS

Premature scaling is not a skin disease. It's the primary cause of startup failure, according to a recent Startup Genome blog post. Premature scaling means ramping up your company ahead of the business model.

What Is a Business Model?

Simply put, a business model is how you make money. Over 50 years ago, the Xerox Corporation invented a way to make copies of documents using a technology that kept the paper dry. Prior technologies involved chemicals that wet the paper. The problem for Xerox was that its machines cost thousands of dollars. In the middle of the 20th century, that was more money than customers were willing to pay, even though everyone preferred dry copies to the wet ones.

Xerox solved that dilemma and became one of the largest companies of the time by modifying its business model. Instead of selling the machines, or even leasing them, Xerox put together a lease package that included a fixed number of copies per month and a set charge for every copy over that amount. (I believe it was 2,000 copies free and a few cents for every copy over that – but don't hold me to those numbers.)

Here's the reason it worked. People made the purchase decision based on their history with wet copies, and figured the monthly fee would be a

bargain. But the new technology meant people made a lot more copies than they had predicted, and they were happy to pay for them because of the quality.

It wasn't the technology alone that made Xerox a success. The business model made it work. Xerox lost its edge when companies in Japan made smaller and cheaper machines, thus creating a different business model around the same technology. But that's a story for a different time.

Recently, a Connecticut Innovations portfolio company, Continuity Control, has been reworking its business model. The company developed technology that helps community banks and credit unions with their regulatory compliance. It's cloud-based software, and the company started selling different modules as apps with monthly fees that all integrated into a complete solution but allowed clients to start simply. Business was slow to take off. Clients were hesitant because they didn't see how all the parts would integrate into a complete solution, and they were cautious following the financial collapse of 2008. So the company bundled a set of apps with a few days of setup assistance from a virtual compliance officer. Continuity Control also included some time with a trained individual to help clients customize their app configurations and offered clients credit to purchase some additional apps. Simultaneously, Continuity Control raised the price. Sales became quicker to close – and much more profitable.

Then Continuity Control made further tweaks to optimize the business model. Now it sells a complete automation platform for compliance management bundled with seasoned regulatory expertise – for an even higher price. Yes, the app technology is still vital, but it's no longer the primary selling point; the value-added regulatory expertise, customization and setup assistance are the key selling points. Sales have continued to grow.

The Business Model Formula (Simple Version)

The business model is about how you solve a customer's problem in a profitable way, and there's a useful formula you can use to understand it. Every dollar your company spends is spent for one of two reasons: either to acquire a customer or to serve that customer. What you spend for the second reason (to serve a customer) subtracted from all the money the customer pays you (over as many purchases as they make) is called the lifetime value of that customer, or **LTV**. What you spend to acquire that customer – all your marketing and sales expenses – is the customer acquisition cost, or CAC.

Obviously, the LTV needs to be more than it cost you to acquire that customer or you're paying the customer to buy from you. To say it another way, LTV minus CAC should be a positive number, or **LTV – CAC = $$**. This is not traditional accounting, of course. Financial reports tell you *what* you spent money on; the business model shows *why you*

spent it. If the result is a positive number, then you've found a model that can scale.

The Job of a Startup Is Not to Sell Product!

The job of a startup is to learn – to develop a scalable business model that will lead to profitability. You've done that when you have documented everything it costs to acquire a customer, including things like knowing how long the sales cycle is and what you have to spend in overhead during that time. Plus you've documented everything it costs to serve that customer, including not just the cost of goods sold, but the cost of building the platform to deliver those goods. Also, you've determined the optimum selling price and how often the typical customer will buy from you. These numbers help you determine LTV and CAC. And finally, you've got data to back up these numbers so they are repeatable, and predictable.

Using the Xerox example, you can see that plugging in the numbers when you're attempting to sell a multi-thousand-dollar machine results in a very different model than when you're selling a monthly lease plus a bunch of copies that cost a few cents. Same machine, same benefit to the customer, but very different business models.

Not every startup needs to invent a completely new business model. Advertising is an old one that works for many companies, freemium is not unique, and subscriptions have been around since before the web.

And of course, selling a single product at profit has been done since money was invented. But you have to discover the business model that works in your situation, based on what your customers are willing to pay to solve the problem that your company solves for them.

Startups vs. Scale-ups

Once you've discovered the right business model for your company, it's time to scale up. That means adding capacity – to acquire customers and also to serve them.

The Business Model Formula (Advanced Version)

If you're scaling up, you need the more complex version of the formula **(LTV – CAC) * N = $$** where N is the right number of customers for profitability. Spending money on N means you're increasing your capacity to sell more and to serve more customers. The trick is keeping those two things in balance and not running out of cash while you grow.

What About Investors?

You may have noticed that you don't see investors in either version of the formula. You usually have to spend money *before* customers pay you. It's investors and lending sources that front you the money, before the customers start paying. Of course, they want to get their money back – and then some – so the costs of paying them back must be incorporated into your model. Depending on what you spend the

money on, those costs show up either by increasing your CAC, decreasing your LTV, or both. That will show how big N needs to be so you can pay back the money out of future cash flow, or grow fast enough to give investors a good return when you sell the company.

That's the business of business models in a nutshell. Simple, right? Deceptively so. Of course simple doesn't mean easy. If it were easy, everyone would get it right.

By John Seiffer

John Seiffer runs CEOBootCamp.com and is president of the Angel Investor Forum of Connecticut. He's been an entrepreneur since 1979 and lives in Milford, Connecticut. You can contact him at john@CEOBootCamp.com.