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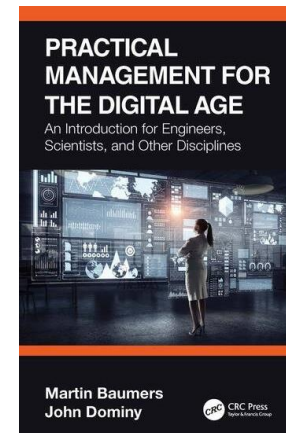
New business formation



What we will talk about today:

New business formation

- *What is remarkable about new businesses?*
- *Perspectives on starting a business*
- *De-risking the process by buying into an existing business*
- *Funding the new business*
- *Qualities of the founders*
- *Business plan writing*
- *Brief lecture summary*



*Lecture builds on Chapter 8 in
Baumers and Dominy (2021)*

What is remarkable about new businesses?

Starting a new business is always an extremely difficult and risky undertaking. It is difficult to successfully achieve by large organizations with extensive resources and it is even more challenging for private individuals on a small budget

- Creating a new business is also an intensely social process relying on close communication between people and establishing considerable trust with others
- New businesses must be small enough to respond successfully to changing and unforeseen situations
- The main objective of a new business is to do new business with yet-to-be-convinced customers which is by definition an undertaking fraught with uncertainty...



Definition of a new business

“A new business is an organization attempting to establish a viable and profitable business model under conditions of extreme uncertainty. New businesses are temporary because they either transition to being an established business or they fail and cease to exist.”

→ We will be using “startup” as a synonym for a new business

Reality check

Some (unverifiable) data from surveys:

- 65% of respondents in one survey stated that they wanted to start their own business and an additional 14% of respondents stated that they were not sure
- The vast majority of new businesses will fail, with the majority of estimates suggesting a failure rate of around 90%
- If there are multiple “funding rounds” the average rate of failure to receive additional funding is approximately 68%
- The average rate of failure for investors to exit through acquisition or IPO is 81.2%
- Only 56% of new businesses survive the first four years of their existence, only 40% of all startups become cash flow positive and only 30% break even

What happens when a new business fails...

For most stakeholders, including the founders and the employees, failure will generally mean that the business is unable to continue operating and they will become unemployed.

- In businesses with unincorporated legal forms, this will simply mean that the business will stop trading and it will attempt to dissolve all its contractual obligations, against which the founders are personally liable
- For incorporated legal forms, the situation is more complex and involves winding up, which is a process of voluntary or compulsory liquidation in which the objects the company owns are sold to pay for the debt the business has accumulated

The failure of a new business is normally an acrimonious process in which stakeholders lose part or all of their investment!



Perspectives on starting a business

That there are significantly different ideas about how the process works and what the relevant elements of the process are.

We will characterize three common types of characterizations of the process of starting a business:

- *naïve procedural approaches*
- *startup life cycling*
- *funding ladders*

Naïve procedural approaches

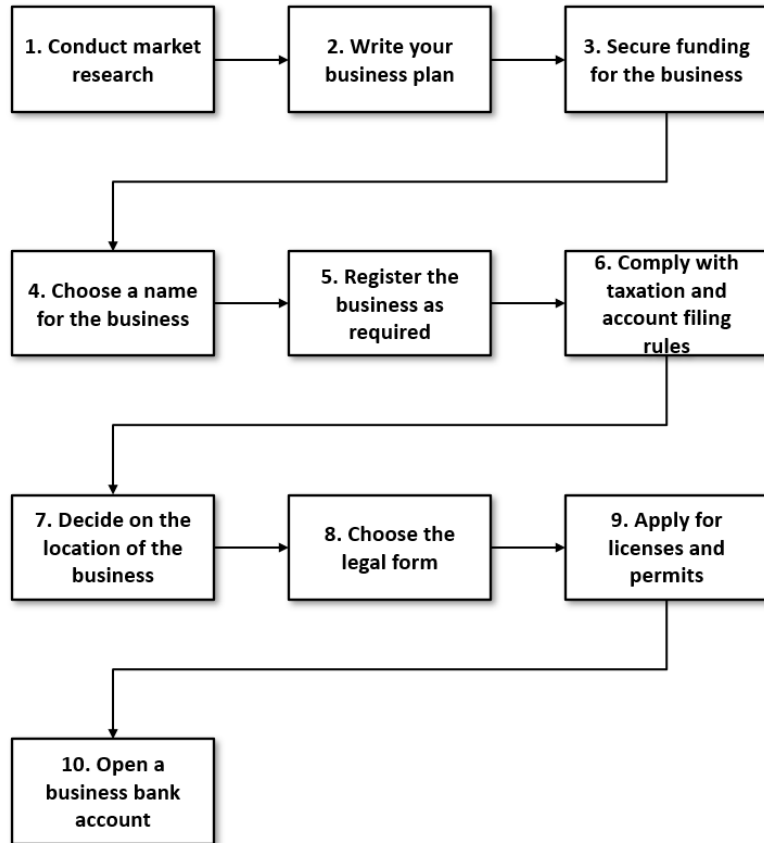
Starting a business requires the entrepreneur to confidently handle a breadth of tasks and issues, none of which are likely to lie in the entrepreneur's area of specialization. These include:

- Finance
- Sales
- Marketing
- Securing intellectual property
- Managing human resources
- Handling legal issues
- ...



→ *This breadth of activities is often described by presenting the process of creating a business as following a sequential procedure of predefined steps.*

Two examples



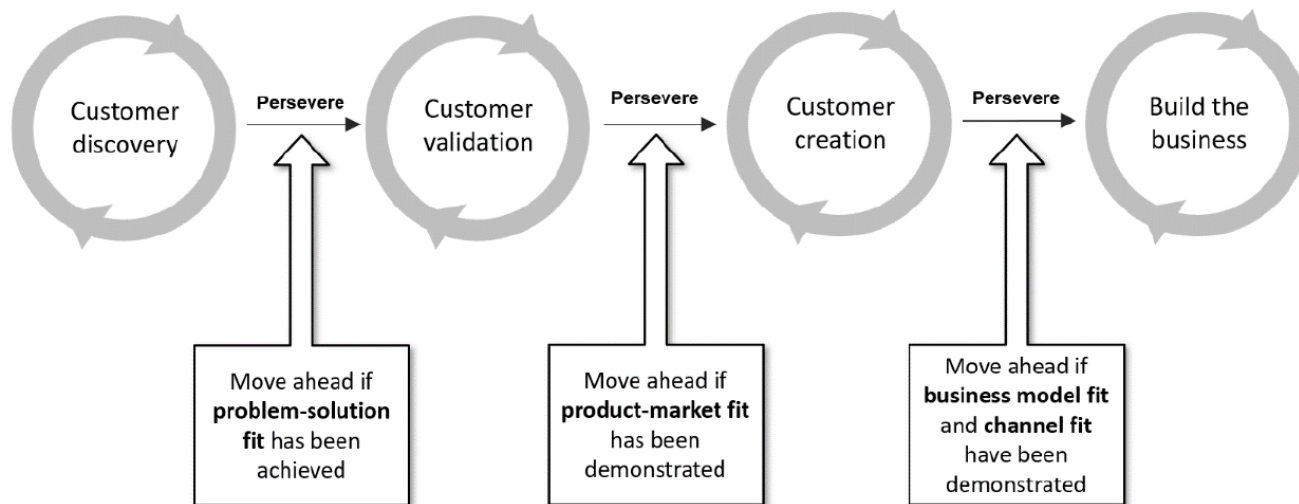
Steps needed to start a business (in no apparent order)

1. Understand the requirements of starting a business.
2. Protect the founder's interests by adopting an incorporated legal form.
3. Select a suitable name for the business.
4. Develop a viable product or service, but do not take too long.
5. Set up a suitable website for the business.
6. Develop a short verbal presentation, called *elevator pitch*.
7. Form a clear written agreement with the co-founders.
8. Register with the relevant tax authorities.
9. Adopt and set up an accounting system.
10. Conduct full reference checks for employees.
11. Sign appropriate employment contracts with staff.
12. Require staff to sign confidentiality and invention assignment agreements.
13. Secure the protection of intellectual property.
14. Develop personal sales skills.
15. Develop an understanding of financial plans and statements.
16. Market the business intensely.
17. Employ contractors to support the founding team where necessary.
18. Develop an effective presentation for potential investors.
19. Ensure that the business website is gets high traffic.
20. Ensure that the targeted intellectual property does not exist elsewhere.
21. Develop an effective business plan.
22. Obtain funding for the business.
23. Obtain the required permits, licenses and registrations.
24. Set up the business records.
25. Obtain the appropriate level of insurance for the business.
26. Allocate the shares between the co-founders.
27. Consider the options of venture capital financing.
28. Exercise diligence when entering into contracts.
29. Exercise a systematic approach to leasing business premises
30. Research the competition in an ongoing way.
31. Consider investments from private individuals, *business angels*.
32. Consider stock options to incentivize employees.
33. Provide excellent customer service.
34. Use the services of a suitable business lawyer.
35. Develop public speaking skills.

Startup life cycling

The logic of startup life cycling is to break complex processes up into a more manageable sequence of discrete steps:

- *Customer development* breaks new business formation up into four stages: customer development, customer valuation, customer creation, and building the business.



The significance of customer development is that it de-risks new business activities by minimizing the need for founders to risk everything in leaps of faith with potentially catastrophic consequences.

Funding ladders

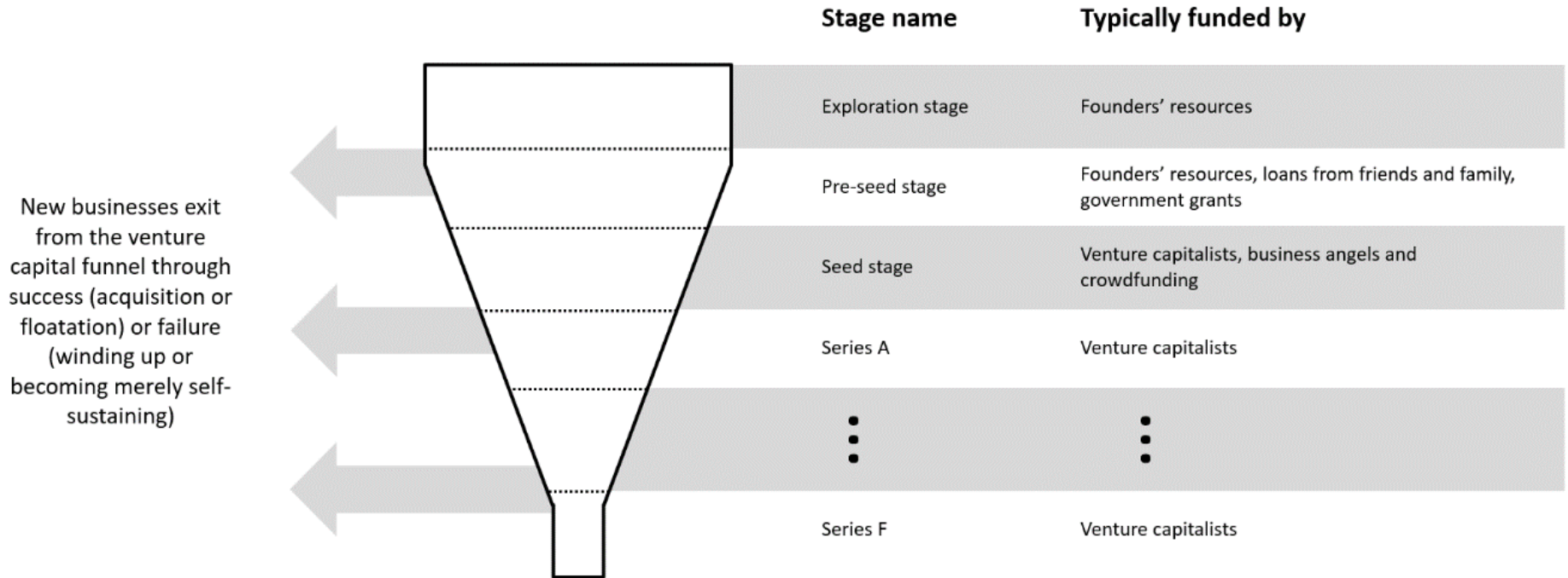
Despite the popular narrative, in many cases this expansion in activity cannot be funded through solely through the company's own retained profit:

- This means that additional funding from investors is normally needed.
- The process of forming a new business is frequently viewed as the sequence of funding events through which the entrepreneurs are able to raise money from outside investors
- Normally this happens in exchange for shares in the business
- Collectively, this process is known as a *funding ladder*

Filter! →



A funding ladder: the venture capital funnel



Buying into an existing business

An alternative to starting a new business from scratch is for entrepreneurs to acquire a part or unit of an existing business. This carries the advantage of adopting a business model that has been validated over a period of time and has generated profits in the past

There are three main pathways for entrepreneurs to obtain ownership of an existing businesses:

- *Buying a franchise*
- *Buying into a partnership*
- *Buying a business*

Entering into a franchise agreement

- There are many forms of franchise, but a good example is McDonalds
- The “owner” buys into the name and advertising of the existing business
- They will rent or buy the premises but will buy equipment, supplies etc. from the parent company
- Their relationships can be quite complex in terms of the agreements regarding who takes what of the profit etc., but can provide a relatively easy way of taking advantage of an established name



Buying into a partnership:

- The businessperson will effectively buy part of a business
- They may possibly have worked there before – lawyers and dentists often work this way
- Alternatively, buy in if the existing owner needs more funding
- Possibly buy in where they have particular expertise which is of advantage to the business
- In partnerships limited by shares, this will entail buying shares in the company!



Buying a business outright

- This is where a business is offered for sale and the businessman simply buys it and takes it over
 - There is a market for businesses!
- The business might be for sale for a clear and obvious reason, such as the owner wishes to retire
- However, it is clearly down to the buyer to make sure that the position of the business is as claimed
- The price is usually based on the turnover, stock and good will



Success criteria for buying a business

- The new owner must match the potential business to his or her own personality
- For example, if they simply wish to make a reasonable living then sell the company on retirement, it is important that they do not take on a business that requires constant expansion and complex finance
- Similarly, where there is more than one owner, it is important that they have the same objectives:
 - If one wants to make a basic income and have fun doing as little as possible, and another wants to become a rival to Bill Gates in three years, then disaster looms!



Funding the new business

In most cases, the formation of a new businesses will require some funding from external sources:

→ *The entrepreneur will normally plan to set up the business with the minimum level of funding required.*

The required level of funding is usually related to the following points:

- *Financial planning can be performed, resulting in a profit & loss budget and a cash flow forecast*
- *Founders should secure as much funding from outside sources as possible since this gives more time and resources needed to correct errors*
- *Founder must include their personal living expenses when planning the new business*
- *Risk management techniques should be used*
- *Budget should be allocated towards professional fees and services, such as an accountant and legal advice*

Burn rate and runway

The “burn rate” is normally used to track the amount of cash that a company spends every month before it starts generating its own income. In terms of the standard cash flow model, the burn rate corresponds to the negative cash flow, measured monthly basis, before the business starts generating revenue.

The burn rate is also used to determine the time a new business has before it runs out of money.

→ *This is known as “runway”. Runway is calculated using the business’ overall initial funding and the burn rate as follows:*

$$\text{Runway} = \frac{\text{Total initial funding secured}}{\text{Burn rate}}$$

- *Simple numerical example in the notes!*



Sources of funding

Several sources of funds can be approached to acquire the funding required to start the business. It is assumed that the initial exploration of the viability of the business will be supported by the founders' own resources...

Family, Friends (and Fools) - FFF

- The usual advice is to see if families and friends are interested in investing.
- This is often the cheapest source, although it is important to make sure that they understand the true nature of the business and the risks involved
- One must also consider the effect on relationships if the enterprise were to fail



Loans from high-street banks

- Under normal economic conditions banks will often support a new enterprise if presented well enough
- However, they will probably require that the applicants put in a considerable amount of their own cash (“have skin in the game”):
 - They will want some form of security if the business was to fail
 - This will often be the applicant’s house



Private investors (a.k.a. business angels)

In the business world there are private investors, sometimes called Business Angels, who will invest a new enterprise:

- A good example is the “Dragons” in their den on the television
- However, they are likely to demand a share of the company, and that might be significant
- They may even want to control the company
- Here the owners must have a clear idea of what they are prepared to give away in exchange for the investment



Venture capitalists

Venture capitalists are professional investors and a combination of banks and private investors:

- They are organisations that will essentially invest in a company in exchange for equity
- However the relationship can be quite complex in that it is not a simple investment
- They may require repayments on the money that they have invested
- They may also demand control of the company
- It is not unknown for investors to effectively fire the owners from their executive post and put in someone who they consider better suited to the position
- However, they can prove to be very suitable partners and invest considerable amounts in the company

Government organisations

There are, at times, government schemes, national or local, that will give some support:

- However, usually the support is to develop the product rather than support the company directly
- There are also some “soft loans” with favourable interest rates available at times
- These schemes vary over time, for engineering ideas consider InnovateUK providing “match funding”

Innovate UK



Community Funding

This a relatively new phenomenon, often internet based:

- In any community there are likely to be some people looking for investment and some seeking to invest (“amateur investors”)
- The aim of Community Funding is to bring these people together
- Sometimes investment is rewarded by products not money
- Examples:



What does it take?

- Any individual starting a company must have total commitment
- It is no good simply reacting to a dislike of a current job, or unemployment – there must be a true desire to run a company
- The incentive will probably be financial, but there are other motivations, such as the love of a particular technology or social change
- It is fundamental that the new company should provide a living as soon as possible



Next: business plan writing...



Business Plan

['biz-nəs 'plan]

A document that defines in detail a company's objectives and how it will achieve them.

The illustration shows a blue folder with a white checkmark on its cover, a silver pen, and several stacks of white coins, all set against a light blue background.

Elements of a business plan

- Any good business plan contains a number of building blocks that the professional audience will expect
- The correct content and format may depend (to an extent) on country, industry and the nature of the proposed business
- Business plans can be based on templates
 - We will be using a template from The Prince's Trust to explain the main elements found in the “standard” format
 - As stressed, there is no single correct format or template!



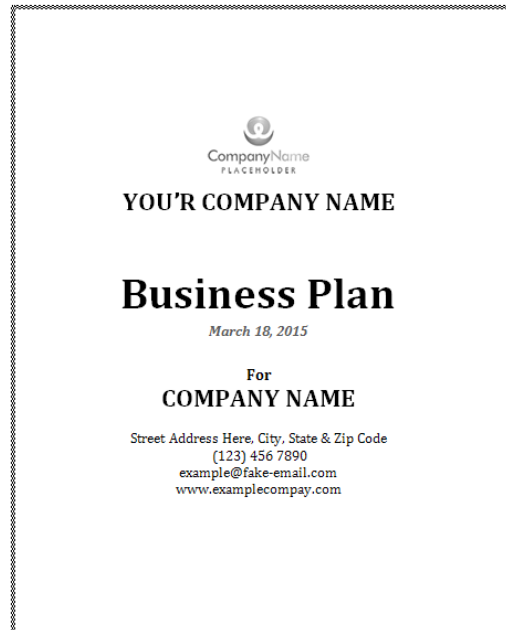
Elements of a business plan (continued)

- The standard format contains the following elements:
 - Formal parts and summaries
 - Founder background and team
 - Exposition of the product or service
 - Market, market research, marketing strategy, competitor analysis
 - Operations plan
 - Costs, pricing and financial analysis
 - Prospects and contingency plans



Formal parts and summaries

- Obviously, the plan needs some sort of cover information



Getting started

Whose plan is this?

Business name:

Owner(s)/Founder(s) name:

Business and owner details:

Business address and postcode:

Business telephone number:

Business email address:

Formal parts and summaries (cont'd)

- The summaries should highlight the attractions of the business
- It should very briefly answer the following questions:
 - What is the business
 - What is the market?
 - Business aims and potential
 - Forecast profit figures
 - How much money is needed?
 - Prospects for the investor/lender
- Suggested length: one or two pages
- Note that the summary will be related to the “elevator pitch” designed for two-minute oral presentation (not part of the business plan)

Section one

Executive summary

1.1 Business summary:

1.2 Business aims:

1.3 Financial summary:

Founder background and team

- Founder: motivation, past employment, business record and achievements
- Team: past employment, business record and achievements
- Expertise, skills and qualifications held
- If there are weaknesses in the team/skills: mitigation plan
- Suggested length: as many pages as needed

Section two

Founder's background and team

2.1 Motivation:

2.2 Previous work experience:

2.3 Qualifications and education:

2.4 Training and future training needs:

2.5 Personal perspective:

2.6 Additional information:

The product or service

- A simple description of what the product or service is and what it does (without jargon)
- Why the product is unique or distinct
- Value proposition?
- Describe different variants of the product or service
- If applicable: how the product is developed, when replacement will be needed, when the product will be introduced
- Intellectual property held or arising
- Suggested length: two pages (plus Appendix if needed)

Section three

Products and services

3.1 What are you going to sell?

3.2 Describe the basic product/service you are going to sell:

3.3 Describe the different types of product/service you are going to be selling:

3.4 If you are not going to sell all your products/services at the start of your business, explain why not and when you will start selling them:

3.5 Additional information:

The market

- Market size, past and future growth
- Analysis of market sectors, target sector
- Likely customers: who, type, size, customer segments, channels
- Existing customers or orders
- Expressions of intent / support from prospective customers
- Suggested length: three or four pages overall (plus Appendix if needed)

Section four

The market

4.1 Who are your customers:

4.2 Describe your typical customer:

4.3 Where are your customers based?

4.4 What prompts your customers to buy your product/service?

4.5 What factors help your customers choose which business to buy from?

4.6 Have you sold products/services to customers already?

4.7 Have you got customers waiting to buy your product/service?

4.8 Additional information:

Market research

- Evidence of market research
- Data collection, methodology
- Test trading, minimum viable products
- Can be combined with the previous section

Section five

Market research

5.1 Key findings from desk research:

5.2 Key findings from field research – customer questionnaires:

5.3 Key findings from field research – test trading:

5.4 Additional information:

Marketing strategy

- How will the product be sold?
Channels?
- Customer relationships
- Sales team
- Concept for sales pitch,
communicating the product value
proposition
- Pricing strategy
- Possible also what marketing will
cost and how it will be funded

Section six

Marketing strategy

<u>What are you going to do?</u>	<u>Why have you chosen this marketing method?</u>	<u>How much will it cost?</u>
<u>TOTAL COST</u>		

Competitor analysis

- Who are the competitors?
- Size, market position, likely response to market entry
- Nature of competitive environment in the industry

Section seven

Competitor analysis

7.1 Table of competitors

<u>Name, location and business size</u>	<u>Product/service</u>	<u>Price</u>	<u>Strengths</u>	<u>Weaknesses</u>

7.2 SWOT analysis:

<u>Strengths</u>	<u>Weaknesses</u>
<u>Opportunities</u>	<u>Threats</u>

7.3 Unique Selling Point (USP):

<u>Unique Selling Point (USP)</u>

Operations

- Location of site, premises
- Key suppliers, key partners
- Manufacturing facilities
- Other equipment, IT strategy and technology
- Even though it is not obvious, this is a section to be creative!
- Suggested length: depends on the nature of the business

Section eight

Operations and logistics

8.1 Production:

8.2 Delivery to customers:

8.3 Payment methods and terms:

8.4 Suppliers:

<u>Name and location of supplier</u>	<u>Items required and prices</u>	<u>Payment arrangements</u>	<u>Reasons for choosing supplier</u>

8.5 Premises:

8.6 Equipment

<u>Item required</u>	<u>Already owned?</u>	<u>If being bought</u>		
		<u>New or second hand?</u>	<u>Purchased from</u>	<u>Price</u>

8.7 Transport:

8.8 Legal requirements:

8.9 Insurance requirements:

8.10 Management and staff:

8.11 Additional information:

Costs and pricing

- Important costs: key resources and key activities
- Revenue streams, willingness to pay
- Competitor prices
- Monetisation and revenue model
- Pricing tactics
- Suggested length: depends on the nature of the business

Section nine

Costs and pricing strategy

	<u>Product/service name</u>	
<u>A</u>	<u>Number of units in calculation</u>	
<u>B</u>	<u>Product/service components</u>	<u>Components cost</u>
<u>C</u>	<u>Total product/service cost</u>	
<u>D</u>	<u>Cost per unit</u>	
<u>E</u>	<u>Price per unit</u>	
<u>F</u>	<u>Profit margin (£)</u>	
<u>G</u>	<u>Profit margin (%)</u>	
<u>H</u>	<u>Mark up (%)</u>	

Financial analysis

- Established formats are available for cash flow forecasts
- Monthly or quarterly
- Simplified example:



→ Remember this?

STARBRIGHT COFFEE					
CASH FLOW FORECAST					
	start (1 week stock)	Q1	Q2	Q3	Q4
SALES REVENUE		900.00	900.00	900.00	900.00
Purchases					
materials: coffee	30.00	225.00	225.00	225.00	225.00
filters	24.00	180.00	180.00	180.00	180.00
milk	17.50	131.25	131.25	131.25	131.25
cups	30.00	225.00	225.00	225.00	225.00
OVERHEAD COSTS					
Porter's fee		37.50	37.50	37.50	37.50
power (elec)			15.00	15.00	15.00
COFFEE MACHINES ETC	350.00				
CASH FLOW OUT	451.50	798.75	813.75	813.75	813.75
CASH FLOW IN	0.00	900.00	900.00	900.00	900.00
NET CASH FLOW	-451.50	101.25	86.25	86.25	86.25
CUMULATIVE CASH FLOW	-451.50	-350.25	-264.00	-177.75	-91.50

Prospects and contingency plans

- Summary of objectives, distinguishing between short term and long term
- Discussion and justification of finance requirements
- Shareholdings suggested (if appropriate)
- Prospects for the investor/lender
 - Future valuation of the business
 - Stock market floatation
 - Investor exit strategy
- Contingency measures if something goes wrong



Examples for business plans and templates

- The Bplans website (www.bplans.co.uk) has a large selection of business plans grouped by industry. Note the rigid format due to the plans being based on the Bplans software product
- Lloyds Bank provides a detailed sample business plan for “ExampleSandwichCo” with a set of detailed financial projections (<http://resources.lloydsbank.com/business-guides/starting-a-business/starting-your-own-business/writing-a-business-plan/#Sample-business-plan>)
- The Startup Loans website (<https://www.startuploans.co.uk/business-plan-template/>) offers a business plan template. Note that this is a commercial provider of finance
- For more information, Greatbusiness.gov.uk is a useful resource (<http://www.greatbusiness.gov.uk/the-how-to-write-a-business-plan-guide>)

Lecture summary in three points



- We've seen that starting a business is *always* risky and in most cases the odds are stacked against the entrepreneurs
- Now have an understanding of how the process of starting the business works and what it entails
- Received an overview of business plan writing...

Question: after this lecture, would you still be interested in starting a business?



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Thank you!