Review the Day One Case Study at the end of Chapter 9.

Compose a minimum of 1,100 words in which you discuss the Day One Case Study:

•Examine what more the members of the Day One team can do to build credibility and improve their chances of securing the capital they need to implement the business plan.

•Discuss what other options might be considered for raising the funds needed to move the company ahead.

•Evaluate if Day One has proven the model yet, given that Andrew has approached you as a potential investor.

•Explain any concerns you may have.

•Explain reasons why you would or would not invest in Day One.

Format consistent with APA guidelines.

Chapter 9:

Grameen Bank Founder and Nobel Peace Prize Laureate Muhammad Yunus speaks during the lecture ‘A world without poverty’ on February 1, 2010 in Milan, Italy. A new business searching for capital has no track record to present to potential investors and lenders. All it has is a plan—sometimes written, sometimes not—that projects its future performance. This means that it is very difficult to raise debt financing from conventional banks because they require as many as three years of actual—not projected—financial statements and assets that adequately cover the loan. Thus almost every new business raises its initial money from the founders themselves and what we call informal investors: family, friends, neighbors, work colleagues, and strangers; a few raise it from lending institutions, primarily banks; and a miniscule number raise it from venture capitalists, who are sometimes called formal investors. This chapter examines funding from entrepreneurs themselves, informal investors, and venture capitalists in the United States and throughout the world. Chapter 10 will explain how to raise equity capital, and Chapter 11 will look at nonequity sources of financing, including banks. Before we examine conventional means of financing startups in medium- and higher-income nations, we'll begin by looking at how many would-be entrepreneurs eking out subsistence livings in some of the most impoverished regions of the world are being financed by microcredit organizations. This chapter is written by William D. Bygrave. Entrepreneurial Financing for the World's Poorest “To ‘make poverty history,’ leaders in private, public, and civil-society organizations need to embrace entrepreneurship and innovation as antidotes to poverty. Wealth-substitution through aid must give way to wealth-creation through entrepreneurship.”1 But the challenge is, “Where do nascent entrepreneurs living in poverty get any money to start a micro-business?” In Africa, for instance, 600 million people live on less than $3 per day based on purchasing power parity (PPP). For China, the number may be 400 million and for India 500 million.2 La Maman Mole Motuke lived in a wrecked car in a suburb of Kinshasa, Zaire, with her four children. If she could find something to eat, she would feed two of her children; the next time she found something to eat, her other two children would eat. When organizers from a micro-credit lending institution interviewed her, she said that she knew how to make chikwangue (manioc paste) and that she needed only a few dollars to start production. After six months of training in marketing and production techniques, Maman Motuke got her first loan of US$100 and bought production materials. Today Maman Motuke and her family no longer live in a broken-down car; they rent a house with two bedrooms and a living room. Her four children go to school consistently, eat regularly, and dress well. She currently is saving to buy some land in a suburb farther outside the city and hopes to build a house.3 In the developing world, 1.4 billion people (one in four) were living below US$1.25 a day in 2005, down from 1.9 billion (one in two) in 1981. Poverty has fallen by 500 million since 1981 (from 52% of the developing world's population in 1981 to 26% percent in 2005), and the world is still on track to halve the 1990 poverty rate by 2015. But at this rate of progress, about a billion people will still live below $1.25 a day in 2015.4 Conventional banking is based on the principle that the more you have, the more you can borrow. It relies on collateral, which means that a bank loan must be adequately covered by assets of the business or its owner—or in many cases, both. But half the world's population is very poor, so about 5 billion people are shut out of banks. For example, fewer than 10% of adults in many African countries have bank accounts. Even in Mexico, the number of families with bank accounts is less than 25%. Microfinancing In 1976, in the village of Jobra, Bangladesh, Muhammad Yunus, an economist, started what today is the Grameen Bank. This was the beginning of the microfinance concept, which is best known for its application in rural areas of Bangladesh but which has now spread throughout the world. Yunus believes that access to credit is a human right. According to him, “one that does not possess anything gets the highest priority in getting a loan.” Even beggars can get loans from the Grameen Bank. They are not required to give up begging but are encouraged to take up an additional income-generating activity, such as selling popular consumer items door to door or at the place of begging.5 The bank provides larger loans, called microenterprise loans, for “fast-moving members.” As of June 2009, almost 1.9 million Bangladeshis had taken microenterprise loans. The average microenterprise loan was US$360, and the biggest was US$23,209 to purchase a truck. The Grameen Bank total loan recovery rate is 97.81%, which is remarkable because the bank relies entirely on personal trust and not collateral.6 Microfinancing is now available in many nations. It is generally agreed that it is a powerful tool in the fight to reduce poverty in poorer nations. The following is a microfinance success story from Mexico, excerpted from an article in The Financial Times.7 Oscar Javier Rivera Jimenez stands on the corrugated steel roof of his warehouse and surveys the urban wasteland around him. “We constructed all of this with the money from Compartamos,” he says. “Before, there was nothing. We built it ourselves. That made it possible. And the help of God as well, which is the secret of everything.” Compartamos is Latin America's biggest provider of microfinance—small loans aimed at budding entrepreneurs, targeted at areas of severe poverty. Mr. Rivera, who set up his business six years ago in the municipality of Chimalhuacan, one of the poorest slums on the outskirts of Mexico City, is one of Compartamos' most successful clients. Starting at the age of 21 by delivering parts on a tricycle—much of the area lacks paved roads, while both water and electricity supplies are unreliable—he now controls an impressive warehouse, where builders can buy an array of different girders. He recently opened a second branch about a mile away. He now has nine employees, four from outside the family—showing that his brand of enthusiastic entrepreneurship might yet rescue the neighborhood. Compartamos (“Let's share” in Spanish) started life as a nongovernmental organization, and gained its seed capital from multilateral funds. Now with more than 300,000 clients, its next plan is to convert itself into a bank, so that it can take in savings and also start to offer life insurance. Its portfolio grew by 58% last year, and Carlos Danel and Carlos Labarthe, its joint chief executives, intend to keep that growth going. By 2008, they aim to have one million clients. Compartamos' average loan is for $330,8 and as is typical of microcredit elsewhere in the world, only 0.6% of its loans are 30 or more days late. Microcredit for the Poorest of the Poor The first Microcredit Summit Campaign was held in 1997. Its aim was “to reach 100 million of the world's poorest families, especially the women of those families, with credit for self-employment and other financial and business services by the year 2005.” In November 2006, the campaign was relaunched to 2015 with two new goals: (1) working to ensure that 175 million of the world's poorest families, especially the women of those families, are receiving credit for self-employment and other financial and business services by the end of 2015 and (2) working to ensure that 100 million families rise above the US$1 a day threshold, adjusted for purchasing power parity (PPP), between 1990 and 2015.9 The campaign defines the “poorest” people as those who are in the bottom half of those living below their nation's poverty line, or any of the 1.2 billion people (240 million families) in the world who live on less than US$1 per day based on PPP. In November 2011, to coincide with the release of the State of the Microcredit Summit Campaign Report 2012 (SOCR 2012), the Microcredit Summit Campaign announced that more than 137.5 million of the world's poorest families received a microloan in 2010—an all-time high, according to a report released today by the Microcredit Summit Campaign. Assuming an average of five persons per family, these 137.5 million microloans affected more than 687 million family members, which is greater than the combined populations of the European Union and Russia. SOCR 2012 provides the data shown in Figure 9.1.10 Year Number of Institutions Reporting Total Number of Clients Reached Number of “poorest” clients reported 12/31/97  618 13,478,797  7,600,000 12/31/98  925 20,938,899 12,221,918 12/31/99 1,065 23,555,689 13,779,872 12/31/00 1,567 30,681,107 19,327,451 12/31/01 2,186 54,932,235 26,878,332 12/31/02 2,572 67,606,080 41,594,778 12/31/03 2,931 80,868,343 54,785,433 12/31/04 3,164 92,270,289 66,614,871 12/31/05 3,133 113,261,390 81,949,036 12/31/06 3,316 133,030,913 92,922,574 12/31/07 3,552 154,825,825 106,584,679 12/31/09 3,589\* 190,135,080 126,220,051 12/31/10 3,652 205,314,502 137,547,441 Source: Maes, J. P. and Reed, L. R. State of the Microcredit Summit Campaign Report 2012. Microcredit Summit Campaign. 2012. p. 35. Figure 9.1 Growth in the implementation of microcredit, 1997–2010 Figure 9.2 shows the relationship between the number of families living in absolute poverty in each region (living on under US$1 a day, adjusted for PPP) and the number of poorest families reached in each region at the end of 2010. Of the 137.5 million poorest clients reached at the end of 2010, 82.3% (113.1 million) were women. The growth in the number of very poor women reached has increased from 10.3 million at the end of 1999 to 113.1 million at the end of 2010. This is almost a 1,001% increase in the number of poorest women reached from December 31, 1999 to December 31, 2010. The increase represents an additional 102.9 million poorest women receiving microloans in the last 11 years. Asia Africa/Middle East Latin America/Caribbean Eastern Europe & Central Asia Number of Poorest Families 182.4 79.8 9   3.4  Number Reached by Microfinance 125.5  8.9 2.9 0.13 Percent Coverage 69% 11% 32% 4% Source: Maes, J. P. and Reed, L. R.. State of the Microcredit Summit Campaign Report 2012. Microcredit Summit Campaign. 2012. p. 39. Figure 9.2 Microfinancing by region, 2010 (in millions) In the following sections, we will examine how entrepreneurs in all financial circumstances, from the poor in developing nations to the well-off in developed nations, raise money to start their new businesses. Entrepreneurs and Informal Investors Self-funding by entrepreneurs, along with funding from informal investors, is the lifeblood of an entrepreneurial society. Founders and informal investors are sometimes referred to as the Four Fs: founders, family, friends, and foolhardy investors. One of the most noteworthy findings of the Global Entrepreneurship Monitor (GEM) studies is the amount and extent of funding by the Four Fs. The prevalence rate of informal investors among the adult population of all the GEM nations combined is 3.6%, and the total sum of money they provide to fund entrepreneurship is equal to 1.2% of the combined gross domestic product (GDP) of those nations. The entrepreneurs themselves provide 65.8% of the startup capital for their new ventures; assuming that the remainder of the funding comes from informal investors, the funding from entrepreneurs and informal investors combined amounts to 3.5% of the GDP of all the GEM nations. The informal investor prevalence rate among the GEM nations participating in the 2009 study is shown in Figure 9.3. Among the G7 nations, the United States and France have the highest prevalence rates (both 3.8%), and the United Kingdom has the lowest (1.1%). The annual amount of funding provided by informal investors as a percentage of the GDP of the GEM 2009 nations is shown in Figure 9.4. The total amount of funding is the product of the number of informal investors and the average amount that each investor provides annually. A nation with a high prevalence rate and a high average amount per informal investor relative to its income per capita—China, for instance—ranks high in Figure 9.4. Russia, on the other hand, ranks low because its prevalence rate and the average amount per informal investor relative to its income per capita are both low. Of course, it is to be expected that in general the wealthier a nation, the higher the average amount per investor. Nonetheless, there is considerable variation, as we can see in Figure 9.5, which compares the average amount per investor with GDP per capita. Informal investors in nations above the trend line provide more investment per capita than predicted, and those below the trend line provide less; for example, Japan and the Netherlands provide more, and Norway, Finland, and the United States less. However, the amount of informal investment in a nation is only one side of the financing equation; the other side is the startup funding needed by entrepreneurs. Figure 9.3 Informal investor prevalence rate, 2009 Figure 9.4 Annual informal investment as a percentage of GDP, 2009 Figure 9.5 Annual amount per informal investor vs. GDP per capita (US$) Amount of Capital Needed to Start a Business The amount of capital that entrepreneurs need to start their ventures depends, among other things, on the type of business, the ambitions of the entrepreneur, the location of the business, and the country where it is started. In the United States, the average amount required to start a business is $62,594, with entrepreneurs providing 67.9% of the funding. For all the GEM nations combined, the average amount needed to start a business is $53,673, and as expected, more is needed for an opportunity-pulled venture ($58,179)$58,179$58,179 than for a necessity-pushed one ($24,467)$24,467$24,467. The amount needed to start a business is highest in the business services sector ($76,263)$76,263$76,263 and lowest in the consumer-oriented sector ($39,594)$39,594$39,594. The businesses that need the most startup capital are those created with the intent to grow and hire employees. For example, nascent businesses that expect to employ 10 or more persons five years after they open require an average of $112,943 of startup money. Business started by men require more capital than those started by women ($65,010 vs. $33,201); a partial explanation is that women are more likely than men to start necessity-pushed businesses, which are more likely to be consumer-oriented and less likely to be business services. To put nations on an approximately equal footing on the basis of wealth, we plot the amount of funding needed to start a business against a nation's GDP per capita, as seen in Figure 9.6. Entrepreneurs in countries falling below the trend line have a comparative advantage over entrepreneurs in countries above the trend line because it costs less to start a business relative to the income per capita in those countries, all other things being equal. This finding partially explains why the United States and Canada have the highest total entrepreneurial activity (TEA) rates among the G7 nations and Italy the second-lowest rate. It might also explain to some extent why Norway has a higher TEA rate than its Scandinavian neighbors Sweden and Denmark. Figure 9.6 Startup funding per company vs. GDP per capita (US$) Characteristics of Informal Investors Entrepreneurs provide 65.8% of their startup capital; hence, others, principally informal investors, provide the remaining 34.2%. Who are informal investors? We can categorize them as follows: close family and relatives of the entrepreneurs (49.4%) are first; next are friends and neighbors (26.4%); these are followed by other relatives (9.4%), work colleagues (7.9%), and strangers (6.9%), as shown in Figure 9.7. Strangers—the foolhardy investors among the Four Fs—are usually called business angels. Relationship: Investor-Investee Percent Total Mean Amount Invested US$ Median Payback Time Median X Return Close family  49.4% 23,190 2 years 1 x Other relative   9.4% 12,345 2 years 1 x Work colleague   7.9% 39,032 2 years 1 x Friend, neighbor  26.4% 15,548 2 years 1 x Stranger   6.9% 67,672 2–5 years 1.5 x 100.0% 24,202 2 years 1 x Figure 9.7 Relationship of informal investor to investee Using GEM data for the United States, Bygrave and Reynolds11 developed a model that predicted whether or not a person was an informal investor. They found that the informal investor prevalence rate among entrepreneurs was 4.3 times the rate among nonentrepreneurs. With just one criterion, whether someone was an entrepreneur, their model correctly classified 86% of the entire population as being or not being informal investors. And with just two criteria, whether a person was an entrepreneur and that person's income, the model correctly identified an informal investor 56% of the time across the entire population, of whom slightly less than 5% were informal investors. Looked at another way, the model was 11 times better than a random choice at singling out an informal investor from the entire adult population. In general, this means that entrepreneurs in search of startup funding should target self-made entrepreneurs with high incomes. More specifically, they should first talk with the entrepreneurs among their close relatives, friends, and neighbors. Financial Returns on Informal Investment What financial return do informal investors expect? The median expected payback time, as you can see in Figure 9.7, is two years, and the median amount returned is one times the original investment. In other words, there is a negative or zero return on investment for half the informal investments. It seems that altruism is involved to some extent in an informal investment in a relative's or a friend's new business.12 Put differently, investments in close family are often made more for love, not money. The amount invested by strangers is the highest. What's more, the median return expected by strangers is 1.5 times the original investment, compared with just 1 for relatives and friends. The most likely reason is that investments by strangers are made in a more detached and businesslike manner than are investments by relatives and friends. There is a big variation in the return expected by informal investors: 34% expect that they will not receive any of their investment back, whereas 5% expect to receive 20 or more times the original investment. Likewise, there is a big variation in the payback time: 17% expect to get their return in six months, whereas 2% expect to get it back in 20 years or longer. Entrepreneurs are much more optimistic about the return on the money that they themselves put into their own ventures: 74% expect the payback time to be two years or sooner, and their median expected return is 2 times their original investment, while 15% expect 20 or more times that investment. The expected internal rate of return or IRR (compound annual return on investment) is calculated from the expected payback time and the times return for informal investors and entrepreneurs who reported both (see Figure 9.8). The returns expected by entrepreneurs are almost the reverse of those expected by informal investors: 51% of informal investors expect a negative or zero return, and only 22% expect a return of 100% or more; by contrast, only 13% of entrepreneurs expect a negative or zero return, but a whopping 53% expect a return of 100% or more. Figure 9.8 Expected IRR for entrepreneurs and informal investors Supply and Demand for Startup Financing Is the amount of funding sufficient to supply the external capital that entrepreneurs need to finance their new ventures? The average amount of an informal investment ($24,202)$24,202$24,202 is more than the average amount of external financing that entrepreneurs need ($18,678)$18,678$18,678. So for those entrepreneurs who are successful in raising money from informal investors, the amount on average more than meets their needs. But is there enough informal investment to supply all the nascent entrepreneurs in a given country? The percentage of nascent businesses that could be funded with the available informal investment, assuming it all went to nascent businesses, is shown in Figure 9.9. Singapore has the highest percentage of nascent businesses that could be funded and Brazil the lowest. Of course, not all nascent businesses deserve to get funded. Without knowing the merits of each nascent business, and hence whether or not it deserves to be funded, we cannot say if the available informal investment is adequate. But it seems likely that a country with enough informal investment to fund 40% or more of all its nascent entrepreneurs probably has sufficient informal investment because, in the end, the majority of new businesses never become viable in the long-term,13 failing to produce a satisfactory return on investment for either their owners or their investors. Figure 9.9 Percentage of nascent businesses that could be funded by available informal investment However, just because a country has sufficient startup capital overall does not mean that every deserving nascent business gets funded. An entrepreneur's search for startup capital from informal investors is a haphazard process. If an entrepreneur is unable to raise sufficient money from relatives, friends, and acquaintances, there is no systematic method of searching for potential investors who are strangers. Granted, there are organized groups of informal investors (business angels) in many nations, but the number of companies they finance is tiny in proportion to the number of entrepreneurs who seek capital. In addition, most business angel networks in developed nations look for high-potential startups that have prospects of growing into substantial enterprises of the sort that organized venture capitalists would invest in at a subsequent round of funding. Venture Capital By far the rarest source of capital for nascent entrepreneurs is venture capital.14 In fact, nascent companies with venture capital in hand before they open their doors for business are so rare that even in the United States—which has almost two-thirds of the total of classic venture capital15 in the entire world—far fewer than one in 10,000 new ventures gets its initial financing from venture capitalists. In general, venture capital is invested in companies that are already in business rather than in nascent companies with products or services that are still on paper. For example, out of 3,698 U.S. businesses in which $26.5 billion of venture capital was invested in 2012, only 1,163 received venture capital for the first time, and of those, relatively few (274) were seed-stage companies. From 1970 through 2012, the venture capital industry invested $556 billion in 41,000 companies at all stages of development.16 It is estimated that over the same period, informal investors provided more than a trillion dollars to more than 10 million nascent and baby businesses. In every nation, there is far more informal investment from the Four Fs than formal investment from venture capitalists (see Figure 9.10). Figure 9.10 Informal investment and venture capital as a percentage of GDP, 2008 Classic Venture Capital While classic venture capitalists finance very few companies, some of the ones that they do finance play a very important—many say a crucial—role in the development of knowledge-based industries, such as biotechnology; medical instruments and devices; computer hardware, software, and services; telecommunications hardware and software; Internet technology and services; electronics; semiconductors; nanotechnology; and clean technology (cleantech). Venture capitalists like to claim that the companies they invest in have the potential to change the way in which people work, live, and play. And, indeed, an elite few have done just that worldwide; some famous examples are Intel, Apple, Microsoft, Federal Express, Cisco, Genentech, Amazon, eBay, Google, Facebook, and Twitter. It's not by chance that almost all the venture-capital-backed companies with global brand names are American; rather, it is because the United States is the predominant nation with respect to classic venture capital investments. In 2008, 74% of all the classic venture capital invested among the G7 nations was invested in the United States. The amount of classic venture capital as a percentage of GDP for the GEM nations is shown in Figure 9.11. Israel, which of all the GEM nations has a venture capital industry most like that in the United States, has the highest amount of venture capital in proportion to its GDP (1.1%), while Italy has the lowest among the G7 nations. Figure 9.11 Classic venture capital investment as a percentage of GDP, 2008 While 74% of the classic venture capital invested in the G7 nations was in the United States, only 36% of the companies that received that investment were there because the amount invested per company in the United States was $8.9 million compared with an average of $1.7 million per company in the other G7 nations. Figure 9.12 shows the amount invested per company for all the GEM nations, including the G7. It is hard to see how companies in Japan, for example, which received on average $972,000 of venture capital, can hope to compete in the global market against companies in the United States that received $8.9 million. It is just as costly to operate a company in Japan as in the United States, if not more so; in fact, entrepreneurs work just as long hours in the United States as they do in Japan. Furthermore, the home market where startups initially sell their products and services is more than twice as big in the United States as in Japan. Although the average amounts of venture capital per company in Germany ($1.4 million)$1.4 million$1.4 million and the United Kingdom ($3.2 million)$3.2 million$3.2 million are higher than in Japan, these amounts still appear to be wholly inadequate in comparison with the United States. And when the nominal amount of venture capital per company is adjusted for purchasing power, the gap between the United States and the other G7 nations is even wider. China and the United States are almost equal in the amount invested per company in nominal dollars, but when purchasing power is considered, China tops the United States by almost 100%. Figure 9.12 Classic venture capital investment per company, 2008 Since the main purpose of classic venture capital is to accelerate the commercialization of new products and services, U.S. companies have a very considerable advantage in the global marketplace. What's more, successful U.S. companies can build on their venture capital backing by subsequently raising very substantial financing with initial public offerings (IPOs) in the stock market. About 80% of the venture capital invested in the United States finances high-technology companies; by contrast, only 29% of the venture capital invested in the other G7 nations, except Canada, is in high-technology companies. Seventy-three percent of the venture capital invested in high-technology companies at all stages from seed through buyouts in the G7 nations goes to companies in the United States. But when the investment is narrowed down to classic venture capital, the proportion invested in U.S. high-technology companies increases to an estimated 80%, with the U.S. share of classic venture capital invested in biotechnology at 81% and in computer hardware and software at 83%. When it comes to investment in all stages of consumer-related companies, the situation is reversed—only 13% of them are in the United States and 87% are in the other G7 nations. Importance of Venture Capital in the U.S. Economy One way of classifying young ventures is by their degree of innovation and their rate of growth17 (see Figure 9.13). In the bottom left quadrant of the figure are companies that are not very innovative and grow comparatively slowly. They provide goods and services that are the core of the economy; for the most part, they have lots of competitors, and they grow at the same rate as the economy. In the upper left quadrant are companies that are innovative but that are not fast growing because for one reason or another they are constrained—often because they are started and managed by entrepreneurs with limited ability. In the bottom right quadrant are companies that are not particularly innovative but that outpace the growth rate of many of their competitors because they are run by ambitious entrepreneurs with superior management skills. And in the top right quadrant are companies that are innovative and have superior management; among them are the superstar companies that attract media attention. Figure 9.13 Financing entrepreneurial ventures in the United States, 2008 Informal investment goes to companies in all quadrants. In contrast, classic venture capital goes only to the companies in the uppermost corner of the glamorous quadrant. They are the companies with potential to become the superstars in their industries—and in a few instances, to be central in the creation and development of a new industry segment. By and large, they are led by entrepreneurial teams with excellent management skills. The companies are usually already up and running when the first venture capital is invested, although in a few rare instances venture capital is invested before the company is operational. Looked at another way, classic venture capital accelerates the growth rate of young superstar companies; it seldom finances nascent entrepreneurs who are not yet in business. A relatively sophisticated subset of informal investors, business angels, invests primarily in the glamorous companies, especially those with the potential to become superstars. Business angels are often entrepreneurs themselves, or former entrepreneurs, who invest some of their wealth in seed- and early-stage businesses. Angel investment frequently precedes formal venture capital. If venture capital dried up in the United States, there would be no noticeable change in the number of companies being started because so few have venture capital in hand when they open their doors for business, whereas everyone has funding from one or more of the Four Fs. But in the long-term, the effect on the economy would be catastrophic because venture-capital-backed companies generate a disproportionate number of good-paying jobs and create many of the new products and services. Those companies make a major contribution to the U.S. economy. For instance, by 2010, venture-capital-backed companies accounted for 11% of jobs in the U.S. private sector and 21% of its GDP (see Figure 9.14).18 Jobs Sales 2000 8.7 Million $1.5 Trillion 2010 11.9 Million $3.08 Trillion 2000–2010 Annual Growth 2.9% 6.8% Top 5 States by Employment at Venture-Capital-Backed Companies Headquartered in the State in 2010 California 2,887,063 Texas 1,129,551 Pennysylvania 783,527 Washington 778,579 Massachusetts 775,151 Source: National Venture Capital Association Figure 9.14 Economic Benefits of Venture-Capital-Backed Companies Venture-capital-backed companies employ a high proportion of high-tech workers in the United States. They accounted for 90% of software, 74% of biotechnology, 72% of semiconductor, 54% of computer, and 48% of telecom jobs in 2010. Venture-capital-backed companies, adjusted for size, spend over twice as much on R&D as other companies. In particular, small firms in the venture-dominated information technology and medical-related sectors are big spenders on R&D. Georges Doriot (1899–1987) founded the venture capital industry when he started American Research and Development in Boston in 1946. His venture capital firm made many seed-stage investments, the most famous of which was $70,000 for 77% of the startup equity of Digital Equipment Corporation. (1979 photo) Mechanism of Venture Capital Investing The formal venture capital industry was born in Massachusetts at the end of World War II when a group of investors inspired by General Georges Doriot, a legendary professor at the Harvard Business School, put together the first venture capital fund, American Research and Development. They did so because they were concerned that the commercial potential of technical advances made by scientists and engineers at the Massachusetts Institute of Technology during World War II would be lost unless funding was available to commercialize them. The fledgling venture capital industry grew and evolved; eventually, the most common form of organization for U.S. venture capital funds became the limited partnership. The mechanism of venture capital investing is shown in Figure 9.15.19 At the center of the process are the general partners of venture capital funds, which are limited partnerships with a 10-year life that is sometimes extended. The general partners of venture capital funds raise money from limited partners. In return for managing the partnership, the general partners receive an annual fee of 2% to 3% of the principal that has been paid into the fund. The general partners then invest money in portfolio companies in exchange for equity. If all goes well, the investment in the portfolio companies grows, and the equity is eventually harvested, usually with an IPO or a trade sale to a bigger company. The capital gain on the harvest is shared 80%—20% between the limited partners and the general partners once the limited partners have received back all the principal they put into the limited partnership. The general partners' share is called the carried interest, which is usually 20%. Sometimes gatekeepers (formally called investment advisors) are employed by limited partners to advise them on what venture capital funds they should invest in and to watch over an investment once it has been made. The gatekeeper's fee is approximately 1% of the capital invested. Figure 9.15 Flow of venture capital Historically, the biggest portion of the money invested by limited partners came from pension funds—in both the public and the private sectors—with the balance coming from funds of funds, endowments, foundations, insurance companies, banks, and individuals; however, in 2009, funds of funds overtook pension funds as the top provider. Kleiner Perkins Caufield and Byers: A Legendary Venture Capital Firm Eugene Kleiner and Tom Perkins formed their venture capital firm, then known as Kleiner Perkins, in 1972. Kleiner was one of the founders of Fairchild Semiconductor, and Perkins was a rising star at Hewlett-Packard. It is probably the most successful venture capital firm ever. Today it is known as Kleiner Perkins Caufield and Byers (KPC&B). Headquartered on Sand Hill Road in the heart of Silicon Valley. Since 1972 it has invested in more than 400 companies, among them AOL, Amazon, Compaq, Genentech, Intuit, LSI Logic, Netscape, Sun, and Google. In 2008, KPC&B raised a $700 million fund, Kleiner Perkins Caufield & Byers XIII. The limited partner investors in the 13th fund since 1972 are largely the same ones that have invested in KPC&B funds over the last 25 years or so. This family of funds has been so successful that it is virtually impossible for new limited partners to invest because the general partners can raise all the money they need from the limited partners who invested in previous funds. The $700 million was to be invested by the general partners over three years, mainly in early-stage companies with innovations in greentech, information technology, and life sciences. As we've mentioned, each venture capital partnership (called a venture capital fund) has a 10-year life. If a venture capital fund is successful, measured by the financial return to the limited partners, the general partners usually raise another fund four to six years after the first fund. This, in essence, means that successful venture capital firms generally have two to four active funds at a time, since each fund has a life of 10 years. Financial Returns on Venture Capital A rule of thumb for a successful venture capital fund is that, for every 10 investments in its portfolio, two are big successes that produce excellent financial returns; two are outright failures in which the total investment is written off; three are walking wounded, which in venture capital jargon means that they are not successful enough to be harvested but are probably worth another round of venture capital to try to get them into harvestable condition; and three are living dead, meaning that they may be viable companies but have no prospect of growing big enough to produce a satisfactory return on the venture capital invested in them. Approximately 3,000 of the 41,000 or so companies (about 7%) financed with venture capital between 1970 and 2012 have had IPOs.20 Of the others that were harvested, mergers and acquisitions were the most common exit. In comparatively rare instances, the company's managers bought back the venture capitalist's investment. The highest return on a venture capital investment is produced when the company has an IPO or is sold to or merged with another company (also called a trade sale) for a substantial capital gain. In general, however, trade sales do not produce nearly as big a capital gain as IPOs do because most trade sales involve venture-capital-backed companies that aren't successful enough to have an IPO. For instance, one way of harvesting the walking wounded and living dead is to sell them to other companies for a modest capital gain—or in some cases, a loss. The average post-IPO valuation of venture-capital-backed companies that went public in the five years through 2011 was $777 million21 compared with an average valuation of $142 million for those that were exited through mergers and acquisitions.22 The overall IRR to limited partners of classic venture capital funds, over the entire period since 1946 when the first fund was formed, has been in the mid-teens. But during those six decades, there have been periods when the returns have been higher or lower. When the IPO market is booming, the returns on venture capital are high, and vice versa. The returns of U.S. venture capital are shown in Figure 9.16. Over the 20-year horizon, seed- and early-stage funds outperformed balanced and expansion- and later-stage ones. This is what we might have expected because the earlier the stage of investment, the greater the risk, and hence, the return should be higher to compensate for the risk. The seed- and early-stage risk premium was spectacular for the 20-year horizon (39.7% versus 12.5% for expansion- and later-stage funds) because the 20-year horizon includes the years 1999 and 2000, which were the peak of the Internet bubble, when year-to-year returns on all venture capital funds were 62.5% and 37.6%, with returns on seed- and early-stage funds being far higher. However, the 3, 5, and 10 year returns on seed- and early-stage funds underperformed expansion- and later-stage funds; but in the most recent year, 2012, seed- and early-stage funds outperformed expansion- and later-stage funds. Investment Horizon IRR (%) through September 30, 2012 Fund Type 1 Year 3 Years 5 Years 10 Years 20 Years Seed/Early Stage  8.4 12.9 4.5  4.9 39.7 Later/Expansion Stage  5.4 17.1 8.1 10.3 12.5 Multi Stage  7.5  9.4 3.0  6.8 13.9 All Venture Funds  7.7 12.2 4.5  6.1 28.8 NASDAQ 29.0 13.7 2.9 10.3  8.7 S&P 500 30.2 13.2 1.1  8.0  8.5 Source: Cambridge Associates LLC. U.S. Venture Capital Index® and Selected Benchmark Statistics Figure 9.16 Venture capital IRRs and NASDAQ and S&P 500 Returns The importance of the IPO market for venture capital is demonstrated in Figure 9.17, which shows the year-to-year IRRs of venture capital and the total amount of money raised by IPOs of companies backed with venture capital. This shows a close correlation between the two lines:when the IPO market is thriving, as it was in 1999 and early 2000, the returns on venture capital are high. Not only do lucrative IPOs directly produce spectacular returns on venture capital invested in the companies going public, but also they indirectly raise the returns on acquisitions and mergers because IPO market valuations tend to set the valuations of all private equity deals. For instance, in 2000 during the Internet bubble, the average valuation for a venture-capital-backed merger/acquisition was $338.4 million, but by 2002, after the bubble burst, the average valuation fell to $52.2 million. Figure 9.17 Venture capital year-to-year IRR and total raised by venture-capital-backed IPOs Google's spectacular IPO in the third quarter of 2004 boosted the confidence of the venture capital industry. Some industry leaders expected that it would herald the start of a new cycle in venture capital investing, with more money being invested in seed- and early-stage businesses. What they were hoping for was another revolutionary innovation that would fire up the enthusiasm of investors such as personal computers did at the beginning of the 1980s and the Internet and the World Wide Web did in the late-1990s. They hoped it would be nanotechnology, but a boom never materialized; next they bet on clean technology; and in 2012 they had high hopes for social media. Clean technology attracted a lot of venture capital, with the amount invested increasing more than10-fold from $0.4 billion in 2004 to $4.5 billion in 2011. Silicon Valley's preeminent venture capital firm, Kleiner Perkins Caufield & Byers, recruited Al Gore as a partner. According to Gore, who was cited for “informing the world of the dangers posed by climate change” when awarded the 2007 Nobel Peace Prize, clean technology will be “bigger than the Industrial Revolution and significantly faster.”23 But an IPO boom in clean technology stocks had not yet occurred by the end of 2012. What's more in 2012 there were some highly visible failures of venture-capital-backed clean technology companies such as Solyndra in solar power and A123 in lithium ion batteries. Returns were dreadful—huge losses in some cases such as A123—for small investors who had bought stock in the few clean technologies that had gone public. Lack of small investor interest in clean technology stocks meant a paucity of IPOs in that sector, which depressed venture capital returns. Then in 2012 venture capitalists believed that social media companies would be the next big thing that could rival the Internet boom. After all, Facebook—the most famous social media company—claimed to have about 1 billion users worldwide when it went public in May 2012. Unfortunately, as you will read in the next chapter, Facebook's IPO went awry for investors—especially small ones—who bought the stock at the IPO and had lost half the value of their investment four months later. Although those who held on to their stocks recovered most of their investment by July 2012, Facebook's IPO did not turn out to be a get-rich-quick bonanza like the Internet IPO boom, and it made small investors wary of IPOs. So in 2012 venture capitalists were still waiting for an IPO boom to boost their returns, which had been unsatisfactory for 10 years because limited partners such as pension funds that provided money to venture capital partnerships could have earned as good a return or maybe better by investing in NASDAQ stocks. Limited partners took notice of the inadequate returns from venture capital and cut the money they commited to new venture funds for four consecutive years from 2007 to 2010; the amount increased in 2011, but was 41% less than the amount in 2006. And venture capitalists became less… what else… venturesome in 2012 because they invested in 38% fewer seed-stage companies than in 2011 and the amount they invested in them was the lowest since 2003. Venture Capital in Europe Since the mid-1990s, venture capital grew rapidly, as most nations strived to emulate the impact that classic venture capital was having on the U.S. economy. It has happened before: at the end of the 1960s, when the United States enjoyed a boom in classic venture capital, and again at the start of the 1980s, when the rest of the world marveled at the success of the personal computer industry and the emerging biotech sector in the United States. Unfortunately, in both instances it turned out to be a false dawn. Returns on classic venture capital outside the United States were—to say the least—disappointing, and classic venture capital floundered. One of the principal reasons for the failure of classic venture capital in Europe at the start of the 1990s was the failure of the secondary markets after the general stock market crash of October 1987. The Unlisted Securities Market in London, the Second Marché in Lyon, the Marché Hors-Cote in Paris, the Mercato Restrito in Milan, and the Secondary Market in Brussels had been significant contributors and enabling factors for the introduction of venture capital in those European countries in the early 1980s because they provided ready markets for floating IPOs of venture-capital-backed companies. Unfortunately, those European secondary markets, unlike the NASDAQ in the United States, did not recover, and so they faded, which left European venture capitalists without their favorite and most bountiful exit route from their investments: IPOs.24 In the late 1990s, markets for IPOs in Europe started to prosper, especially the AIM in the United Kingdom, but just as in the United States after 2001, it again became very difficult to float venture-capital-backed IPOs in Europe; consequently, classic venture capital returns fell and investments declined. Once more it demonstrated that classic venture capital cannot do well without a robust IPO market. Factors Affecting Availability of Financing The three fundamental elements of an entrepreneurial society are an abundance of would-be entrepreneurs, plenty of market opportunities for new ventures, and sufficient resources—of which financing is a major component—for entrepreneurs to launch their new ventures.25 Numerous environmental and societal factors affect the three basic elements, and in combination with the basic elements, they determine the degree of entrepreneurial activity in a region. We will now look at how financing correlates with entrepreneurial activity and the factors that affect the availability of financing. Because GEM includes many nations, we can see how informal investment and venture capital are related to environmental, societal, and governmental factors. Total Entrepreneurial Activity and Informal Investing The prevalence of informal investors correlates positively with the overall TEA index and three component TEA indices—opportunity, market expansion potential, and high job growth potential. And the amount of informal investment as a percentage of GDP correlates positively with two TEA indices—necessity and high job growth potential. Those correlations are convincing evidence that nations with more informal investing have more entrepreneurial activity, but they do not separate cause from effect. Informal investing and entrepreneurship depend on each other: Informal investment facilitates entrepreneurship, and entrepreneurship brings about a need for informal investment. Factors Affecting Informal Investing Money for informal investing comes from a person's after-tax income and savings, which more often than not are accumulated from after-tax income. Thus, it seems reasonable to hypothesize that the higher the rate of taxation, the less likely that a person will have discretionary money to invest, and vice versa. In many nations, especially developed ones, the biggest taxes are social security, income taxes, indirect taxes such as sales tax on goods and services, and taxes on capital and property. For all the GEM nations, the prevalence rate of informal investors is negatively correlated with social security taxes and with taxes on capital and property. For nations with an income of at least $5,000 per capita, the amount of informal investment per GDP correlates negatively with social security taxes, the highest marginal income tax rate, indirect taxes, and taxes on capital and property. Stated another way, nations with higher taxes on individuals have lower rates of informal investing. High tax rates inhibit informal investing. Factors Affecting Classic Venture Capital In contrast to informal investing, the amount of classic venture capital as a percentage of GDP does not correlate with taxes on individuals or corporations. The explanation is that only a small proportion of classic venture capital comes from individuals and corporations. Far more comes from pension funds, which are essentially investing money that has been entrusted to them by others, and hence, they are not directly affected by taxes nearly as much as individuals are. The amount of classic venture capital as a percentage of GDP correlates with the amount of informal investment as a percentage of GDP. This occurs because almost all companies start out with informal investment; then, if they show superstar potential, they attract classic venture capital. Thus, vigorous informal investing paves the way for robust classic venture capital investing. So, although there is no direct link between classic venture capital investment and taxation, there is an indirect link via informal investors, who are influenced by how much they pay in taxes. As we pointed out earlier, there is a correlation between the returns on venture capital and the IPO market in the United States. In turn, this correlation means that the amount of venture capital provided by limited partners depends on the IPO market because, when the returns on venture capital are good, limited partners put more money into venture capital funds, and vice versa. In 2008, for instance, when the one-year return on venture capital dropped precipitously, commitments of new money by limited partners fell 21%. CONCLUSION Financing is a necessary but not a sufficient ingredient for an entrepreneurial society. It goes hand in hand with entrepreneurs and opportunities in an environment that encourages entrepreneurship. Grassroots financing from the entrepreneurs themselves and informal investors is a crucial ingredient for an entrepreneurial society. Close family members and friends and neighbors are by far the two biggest sources of informal capital for startups. Hence, entrepreneurs should look to family and friends for their initial seed capital to augment their own investments in their startups. Many entrepreneurs waste a lot of valuable time by prematurely seeking seed capital from business angels and even from formal venture capitalists—searches that come up empty-handed almost every time. Entrepreneurs must also understand that they themselves will have to put up about two-thirds of the initial capital needed to launch their ventures. YOUR OPPORTUNITY JOURNAL Reflection Point Your Thoughts… How much equity financing do you need to get your business launched? When do you need it? Where will you get your initial financing? How much money can you invest from your personal resources (savings, second mortgage, etc.)? Create a strategy for other equity financing. Build a list and rank order Four F funding sources. Estimate how much each of these investors might be able and willing to invest. Do you think your business has the potential to raise formal venture capital (high-tech, high-innovation, high-growth prospects, first-rate management team, etc.)? If so, when might you be ready for venture capital? How much would you raise? WEB EXERCISE What can you learn about equity financing on the Web? Search for some investor/entrepreneur matching sites (e.g., www.angelinvestmentnetwork.ca). Do you think these services are effective? Would they work for your business? What can you learn about venture capital on the Web? Look at www.pwcmoneytree.com/moneytree/index.jsp. What regions and sectors are receiving the most money? Which venture capital funds are the most active? Are they investing in your sector? 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Venture Capital Investing: A Resource Exchange Perspective. Dissertation, Boston University, 1989. 20 National Venture Capital Association. www.nvca.com/def.html. 21 National Venture Capital Association: Yearbook 2012. New York: Thomson Venture Economics. 22 Ibid. 23 Al Gore's Next Act: Planet-Saving VC. February 12, 2008. http://money.cnn.com/2007/11/11/news/newsmakers/gore\_kleiner.fortune. 24 Peeters, J. B. A European Market for Entrepreneurial Companies. In William D. Bygrave, Michael Hay, and J. B. Peeters, eds., Realizing Investment Value. London, England: Financial Times/Pitman. 1994. 25 This is excerpted from Financing Entrepreneurs and Their Businesses, presented by William D. Bygrave at the Entrepreneurial Advantage of Nations Symposium at the United Nations Headquarters, New York, April 29, 2003. 1 Personal consulting service was offered at $89/hour$89/hour$89/hour, a competitive rate in the Greater Bay area. 2 In addition to a core of standard classes and support groups dealing with childbirth, breastfeeding, and exercise, the center offered other workshops such as Infant & Child CPR, Infant Massage, Musical Play, First Foods, and Practical First Aid & Safety. CASE: DayOne In an uncharacteristic show of frustration, Andrew Zenoff nearly tossed the phone into its cradle on his desk when his latest funding lead—number 182—had decided not to invest. With the 2003 winter holiday season in full swing, the 38-year-old seasoned entrepreneur knew that his fundraising efforts would now fall on deaf ears until after the New Year holiday. Andrew stared out from the open office at a group of young mothers in the retail area—all cradling newborns—chatting with the nursing staff and with each other as they waited for the morning lactation class to begin. Those new moms out there need us; that's why we're doing well despite a terrible location, a recession, and no money for advertising! So why can't I seem to convince investors what a great opportunity this is?! Am I—along with my staff and all of our satisfied customers—suffering from some sort of collective delusion? He closed his eyes, breathed deeply, and calmed down. After all, he quickly reminded himself, his San Francisco–based DayOne Center—a one-stop resource for new and expectant parents—was doing just fine as it approached its third year of operations. What Andrew and his team were being told, though, was that, before funds would flow, they would need to provide additional proof of concept—a second center, sited and scaled to match the DayOne business plan. The chicken-egg challenge, of course, was that they would need about a million dollars to build that proof. Andrew leaned back to consider his best options for moving forward. My Brest Friend A graduate of Babson College in Wellesley, Massachusetts, Andrew was no stranger to entrepreneurial mountain-climbing. For three years, he had strived to build a national distribution channel for My Brest Friend, the most popular nursing pillow in a fragmented market. By 1996, he had secured an overseas manufacturer, office space in a San Francisco warehouse, and a few volume accounts that were yielding a decent—but far from satisfying—cash flow. He was still wrestling with the issue of how to educate the buyer about the advantages of his product when suddenly his venture had come under siege: A nursing pillow company that was not doing well somehow thought that I had copied their design. There was no infringement, but they sued us anyway, and I decided to fight. The owner of this company was a woman with kids, and as the suit dragged on, my lawyers convinced me that, if this thing went to trial, a jury might side with her instead of a guy who has no kids and has never been married. If she won, they'd get an injunction against me, and that would be the end of my business. That year I switched law firms three times, spent over $250,000 on legal fees, and ended up paying a settlement in the low six figures. I was emotionally drained, and nearly entirely out of cash, but I had managed to save my business. A Question of Distribution Following that painful settlement in the spring of 1997, Andrew set about to devise a more effective delivery model for his nursing pillow enterprise. He soon came to the realization that the solution he was looking for didn't exist: We definitely had the best product in the category. The problem was that people needed to be educated to that fact—either outright or through trusted word of mouth. The various channels I had worked with—big retailers, hospitals, Internet sites, catalog companies, lactation consultants—each offered only a certain facet of what a new parent needed, and so none of them had been really efficient at delivering my product to the marketplace. What it needed was a combination of education, retailing, and community. This case was prepared by Carl Hedberg under the direction of Professor William Bygrave. © Copyright Babson College, 2004. Funding provided by the Frederic C. Hamilton Chair for Free Enterprise. All rights reserved. Later that summer, Andrew got a call from one of his customers, Sallie Weld, Director of the Perinatal Center at the California Pacific Medical Center. An active promoter of My Brest Friend, Sallie had come to a frustrating juncture in her own career: During the mid to late 1990s, I had spent a lot of time and energy setting up a new type of perinatal center. New moms were coming in asking for support and advice on various products—breast pumps in particular. When we started carrying pumps, that sort of opened up a Pandora's Box; now people wanted other products to go with the pumps. Andrew's pillow, for example, was the best on the market, so we started carrying that. And after a couple of years, this retail aspect of our childbirth and parenting education program began to turn a profit—and the minute it did, the hospital got greedy. They told us that we were not going to be able to hire more trained staff to handle the increased demand for our consults, and they said that all of our retailing profits would be channeled back into the general fund to support other departments. That was incredibly frustrating. I knew I was onto something, though, and I started a consulting business to help other perinatal centers. The problem was, they couldn't pay much for my services. That's when I decided to give Andrew a call. They agreed to meet at Zim's Restaurant, an aging diner in the upscale Laurel Hill neighborhood of San Francisco. It was a meeting that would change their lives. DayOne—Beginnings In August 1997, Sallie and Andrew met at Zim's for coffee and carrot juice, respectively. Sallie explained that no single service provider had ever been able to adequately serve the various needs of new moms: A hospital setting would seem to be the natural place to set up an educational support and product center for these women, but the bureaucracy just won't let that happen. There are also plenty of examples where nurses have tried to offer outside consulting services to new mothers, but while that's a great thought, they never seem to get very far without the business and retail component. And retailing without knowledgeable support is just products on a shelf. After 90 minutes of brainstorming, the pieces suddenly fell into place. Andrew had found the unique distribution model he'd been searching for: I said to Sallie, “Let's move these hybrid health-services retailing ideas into a private care center outside of the hospital—a retail center that could provide new and expecting parents with everything they needed in one place.” We'd be backing up the hospitals and supporting women at a critical and emotionally charged period in their lives. This was like a lightning bolt of a vision for both of us, and at that moment, we decided that we were going to build a national chain of these centers. That was the beginning of DayOne. Having already built one business from scratch, Andrew noted that he wasn't surprised that it was months before they were ready to take a material step: I had told Sallie that, even though this sounded great, she shouldn't think about quitting her job at the hospital until I had a chance to lead us in an exercise to see if this business was a viable idea. I conducted a ton of focus groups, and every week Sallie and I would get together to talk about what I had learned—and what kind of center DayOne would be. After about nine months, in the summer of 1998, we decided, yes, this makes sense; let's do it. Seed Funding Andrew called investor Mark Anderssen, a shareholder and an active supporter of My Brest Friend. When Mark seemed receptive to the DayOne concept, Andrew paid him a visit: I flew to Norway to meet with him in person. I was sure that after we opened up one of these, we'd be able to attract enough capital to start a chain. I figured that we would need about $300,000 to fund the next year and a half; we would be writing the business plan and working on the build-out requirements so that, when we were ready, we could move through the construction process quickly and get it opened. He said great and put up about half the money to get us started. As Sallie focused in on staffing requirements and retail offerings, Andrew began writing the plan, defining the target market (see Exhibit 9.1), designing the space, and looking for the right retail location: upscale, ground floor, easy parking, with excellent signage potential. That summer, about a year after their momentous meeting of the minds, the Zim's restaurant block fell to the wrecking ball to make way for a brand new office and retail complex. Andrew saw that the location was close to the hospitals, was in a vibrant retail area, had good stroller accessibility, and offered lots of parking. When the developer pointed out the street-level retail availability on the blueprints, Andrew saw that it was precisely where Zim's had been; DayOne would be growing up in the exact spot where Andrew and Sallie had had their first meeting. Andrew secured the space with a sizable deposit, engaged the architects, and scheduled a contractor to handle the build-out. With their sights now set on an April 2000 Grand Opening, Sallie left her job to become DayOne's first paid employee. Everything was on schedule and proceeding as planned. Then, suddenly, nothing was. Scrambling to Survive In January, Andrew contacted his funding partner for the other half of the seed funding allocation. The investor, who had recently suffered some losses in high tech, explained that he would be unable to extend any more money. Andrew was in shock: Things were already rolling along; I had architects working, Sallie and two assistants on payroll, a huge locked-in lease—and now, suddenly, with the bills mounting up, we were out of capital! Andrew had been pitching the DayOne vision to other investors all along, and that same week an individual came forward with a substantial amount of money to invest. Andrew explained that, while the promise of cash got him motivated, he soon concluded that this wasn't just about the money: This investor approached me and said that since I clearly understood the baby industry, he could get me a million and a half bucks for an Internet company. So I spent four weeks trying to figure out how I could do this on the Internet. Then I realized that, even though I probably could come up with something, it wouldn't really provide new parents with what they needed. And so I went back to them and said that I can't do it; it's not in line with my values and my beliefs. EXHIBIT 9.1 Business Plan Excerpt: The Market According to the United States Department of Health and Human Services, women in the United States are having more children than at any time in almost 30 years. With four million births annually—more than half are first-time parents—the United States produces more than 2.2 million potential new customers each year. Indeed, the current baby boom is projected to continue until 2018. Spending an average of $8,100 on baby-related products and services during their baby's first year (excluding primary medical care), new parents represent more than $17.8 billion in annual purchasing power. In recent years, the size of the juvenile products industry alone—i.e., products for babies 0–18 months—has grown to $16 billion annually. The company plans to reach the most commercially attractive part of this market—approximately 1,350,000 first-time parents each year with a college education and at least middle-income households. Additionally, the company expects to reach the market of more than 1,000,000 second-time parents annually, who comprise 25% of DayOne's target customer base. The percentage of women in the United States who choose to breastfeed their babies continues to rise dramatically each year. According to a 2001 survey of 1.4 million mothers, the prevalence of breastfeeding in the United States is at the highest rate ever recorded, with 69.5% of new mothers now initiating breastfeeding, and 32% still breastfeeding at 6 months. (Breastfeeding Continues to Increase into the New Millennium, Pediatrics, Vol. 110, No. 6, Dec. 2002.) Moreover, 78.3% of college-educated mothers with household incomes of greater than $50,000 breastfeed versus a national average of 59.2%, and 59.2% of second-time mothers are breastfeeding. As an ever-increasing number of studies confirm the advantages of breastfeeding for babies' immune systems and intellectual development, DayOne expects the incidence of breastfeeding to remain on the rise. Indeed, according to the U.S. Department of Health and Human Services, 75% of all first-time mothers will try to breastfeed their child compared to less than 50% only 15 years ago. More than two-thirds of breastfeeding women experience difficulty during breastfeeding and seek outside help. The majority of these problems surface after the brief hospital stay, when access to hospital-based lactation consulting programs is no longer available. Most mothers first turn to their pediatricians and OBGYNs, who are increasingly referring first-time mothers to lactation consultants because they lack the time and specific expertise. DayOne provides pediatricians, OBGYNs, and new mothers with a high-availability support solution. There are numerous other market factors that favor DayOne's solution: The existing market is highly fragmented. In order to receive necessary services, products, and support, new and expectant parents must navigate between baby specialty stores, catalogs, Internet sites, hospitals, and independent childbirth educators and lactation consultants. Pregnant women and new mothers desire community for support, information, and the opportunity to share common experiences. Hospitals continue to downsize, reducing staffs and shortening the duration of maternity visits, forcing new mothers to rely on outside sources for needed support and services. Baby specialty stores continue to disappear off of the retail landscape in the face of big-box operators, reducing the personal touch that new parents seek. Although he was now sure that the DayOne model wouldn't work as a Web business, Andrew saw that there still might be a way to leverage the red-hot Internet space to garner the funding he so desperately needed: I met with a big online company that was doing baby-related things and told them that I thought their model had issues; first-time parents need to touch and feel and learn before they buy. I suggested that in order to survive long-term, they would need to partner with a bricks-and-mortar business like the kind we were building. Well, at the time their stock was worth several hundred million; those two guys told me that they were doing just fine and that they had no interest in what we were doing at DayOne. You know, a year later, they were out of business. DayOne centers were designed to be a key distribution channel for Brest Friend products, so Andrew aggressively leveraged resources at his wholesale venture in an effort to keep the flagship store on schedule. That had worked well for a while, but ever since Andrew began working long hours to open DayOne, sales of his nursing pillows had fallen precipitously. It was now achingly clear that, if this innovative distribution concept failed, My Brest Friend would be facing a long road back. By March 2000, DayOne had amassed $200,000 in payables that Andrew couldn't begin to cover—at least not in the near term. Two architectural firms had already walked out on the project when they became aware that the startup was suffering from a severe funding gap. Andrew convinced the third one to come on board by pointing out that he himself wasn't drawing a salary—that his partner Sallie had resigned from a good job at the hospital to do this, and that they had already begun to interview and hire additional staff. This was real; they would find a way. That's just about the time that things began to get really ugly. Nightmare on the Second Floor By mid-March, DayOne had endured 45 days without cash, and Andrew had spoken with nearly 50 investors, without success. The landlord called. Construction, it seemed, was behind schedule—a fact that, under the circumstances, suited Andrew just fine. When the landlord requested a face-to-face meeting as soon as possible, Andrew was pretty sure that the guy wasn't calling him in to apologize a second time for the occupancy delay: The landlord tells me that because of our financial position, they are not going to let us have a ground floor space; he's afraid that DayOne couldn't cover the rent. He says the only space they have for us is on the second floor—end of story. I said, “I don't know what to do; I don't have the money. I need to get out of this lease.” He said, “Well, you're on the second floor, and you can't get out of the lease.” Great; a lease for a top-floor space that I couldn't pay for. Andrew returned the following day with a stronger argument: I said look, you can't squeeze blood from a stone. And anyway, I am out of this lease because your building has taken so long to deliver that my investors have backed out! I told him that I can't honor the lease because he hadn't honored his deal. He didn't really respond to me, but we both knew that I was all done. Andrew was trying to visualize how he was going to break this devastating news to his partner Sallie when he received an astounding call on his cell phone: I had been pitching the business plan to everyone I could think of and hadn't gotten anywhere. All of a sudden here was an investor calling to say that he and three others were interested in putting up $150,000 apiece. $450,000 was about half of what I would need to open, and a lot less than the $1.5 million I was trying to raise as a first round. But it was a start; I pushed the “Go” button again. I went back to the real estate guy and said, “You know, you're right; even if this is on the second floor, this is my space. I'll keep it.” That's when he told me that he had already rented out half of our space to someone else. So, not only were we going to be way in back on the second floor with half the space we needed, but also we were now going to have to pay to completely reconstruct our architectural drawings. Understanding that he was still a half a million dollars shy of what they would need to open the doors, Andrew continued to dole out just enough money to keep his various service providers on board. In June, the landlord informed him that the building was now ready for occupancy—meaning that the first $10,000 monthly rent payment was due. Andrew made sure to pay that bill on time, and in full. Grand Opening The construction business, like many trades, was a close-knit community of craftspeople and professionals. It was not surprising, then, that word was out on the slow-paying, underfunded project up on Laurel Hill that had already gone through three architectural firms and at least that many plan revisions. After a long search, Andrew located a contractor who apparently was not aware of DayOne's precarious financial situation. Along the way, he had signed up another minor investor, so when construction began in August 2000, DayOne had $480,000 on hand. In late November—as the build-out neared completion—the contractor suddenly announced that he would not release the occupancy permits until he and his crew were paid in full for the work they had completed. Andrew recalled that it was another one of those pivotal moments: I owed these guys something like $200,000, and I didn't have anything left. I just wanted to get to the opening party in January because I felt that, if we got enough people to come and enjoy it and get excited about what we were doing, we'd be able to raise the money we needed. I convinced the contractor to let us open, and at that party, two different guests pulled me aside and said that they wanted to invest. One woman wired me $50,000 the following Monday without so much as glancing at the business plan. I got another $50,000 from a couple who had just had their baby. When we officially opened later that week, the contractor was paid in full, but we were again out of money. As they had always planned to do, Andrew and Sallie called the area hospitals to let them know that DayOne was open for business and ready to serve. Andrew recalled that the response from the medical community took them completely by surprise: One reason we thought we could make do with a second-floor location was because our plan had always been to drive traffic by being the type of place that medical professionals would want to send their patients. Instead, hospital directors were telling us that they considered us to be the competition and that they were going to tell all the docs in San Francisco not to support our efforts in any way. With no help from the hospitals, ineffective signage, cramped facilities (see Exhibit 9.2), and no capital for marketing and advertising, Sallie and Andrew were faced with a harsh reality: Either customers would love the experience enough to spread the word, or their business would quickly wither and die. EXHIBIT 9.2 Signage and Facility Delivering a Unique Customer Experience DayOne immediately began attracting a base of young, mostly affluent new and expectant moms seeking advice on everything from the latest baby carriers to sore nipples. Many signed up for the $99 annual membership on the spot to take advantage of discounts offered on programs and workshops (see Exhibit 9.3). Some dropped by out of curiosity or with specific questions for the professional staff. Sallie quickly established a ground rule that she felt struck a fair balance between the needs of these mothers and the need to advance the business: When someone comes in with a question, we have a 10-minute rule. If your question is so involved that one of us cannot answer it in 10 minutes, then you need to make an appointment, and we need to charge you.1 Ideally, these are people who are members, but many times, if they are not, we can convert them by giving them those 10 minutes and maybe recommending some classes or products right there on the shelves that might be just what they were looking for. And they leave here thinking, wow, where else can I go where I can get that kind of knowledgeable service without having to be a member first? EXHIBIT 9.3 DayOne Membership Flyer Sallie noted that, because of their customer-care orientation, she and her nursing staff were always looking out for ways to help—without first trying to calibrate whether a particular act of humanity or assistance would generate profits for the business. Pointing to a basic plastic and metal chair in the corner of her office, Sallie said that she wasn't surprised to see that simple kindness had its rewards: Our favorite story is about that chair. We like new moms to be sitting up straight when they first start nursing—versus a rocking chair. I had one mom—not a member—who said every time she came in for a consult that the only way she could breast feed was in that type of chair. Every time she came in she said it, so finally I said, “Hey, why don't you take the chair home with you until you're feeling more comfortable with the whole process?” She looked at me and said, “Really? So she took the chair home. The next day she became a member, she bought a breast pump from us instead of the one she was eyeing on eBay, and she went around telling all of her friends that we lent her that chair. She brought it back a few weeks later and has become one of our best customers. What goes around comes around, and when we give a little bit, it's such a shock to them that they've gotten good service. I have this rule that if there's a mom hanging out in the rocking chair area, one of us goes over and asks if we could get her a glass of cold water. I swear it's like you've just offered them a million dollars! They'll start to ask you questions, and it almost always turns into a sale. It's so funny—and a bit pathetic—that nobody ever thinks about these moms; everybody talks to, and about, the baby. That's what we do differently. We make them feel good, knowing that if we take care of them, they'll take care of the baby. And all of that is definitely good for business. Despite an encouraging level of customer interest and loyalty right from the start, the retailing side of the business continued to struggle. Andrew knew what the problem was: The thing is, I am not a retailer. So everything we did early on was shooting from the hip. Sallie had some experience selling retail products at the hospital, but she was better on the service side. We had hired one retail buyer who lasted two months; didn't know what she was doing. Then another; same thing. The problem was, these people knew a lot about retailing, but we needed somebody who also understood the baby industry. DayOne had begun to cover its operating expenses by the end of the summer of 2001, but the business was still in dire need of funding. As the capital markets continued to deteriorate that year, fundraising became an even more arduous task than ever before. While the 9–11 terrorist attacks on the East Coast hurt retail sales and drove potential investors further underground, satisfied clients continued to drive new customers to the center. In January 2002, the retail buyer that Andrew and Sallie had been searching for showed up on their doorstep. Ten-year retailing veteran Jennifer Morris had come over from The Right Start, the largest chain of specialty stores for infants and children in the United States. She recounted how she was drawn to the new venture and alluded to why her predecessors might have been overwhelmed by the task: I found out about DayOne through working at The Right Start in San Francisco. I would either see a DayOne tote bag or customers would tell me all about it. I started to investigate and found out that DayOne is not the kind of place you'd stumble onto. I was immediately attracted to the energy in this place; from the customers, the staff, the nurses, to the classes and the workshops, everyone just really seemed to love it. The biggest challenge for us is trying to be a one-stop shop. We have quite a few product categories (see Exhibit 9.4), and I buy from over 100 vendors—sometimes just one item from one vendor. A lot of those decisions are made by listening to our customers. If they come in with a terrific product, we can then go research that item and bring it in. We have no limits on that, really; we carry products from New Zealand, from Australia—from all over the world. If there's a great new product out there, we'll find it. EXHIBIT 9.4 Retail Product Offerings Category Approximate Profit Margins Maternity Products 40% Infant Clothing 54% Nursing Clothes 52% Breastfeeding Equipment 50% Gifts 55% Baby Accessories 47% Infant Safety & Health 57% Book Sales 42% Toys 53% Preemie Clothing 53% Skin Care 47% Hardgoods 44% Bras 51% Food & Beverages 10% Sallie pointed out that in a similar way, she and the nursing staff were always looking for instructors and programs2 that would distinguish DayOne as a premiere care center: We search for the best and invite them to teach their classes here. More and more, though, the good ones come looking for us. We have started a lot of fresh and exciting workshops, but almost immediately other places in town copy what we're doing. Sometimes I wonder how long we can keep it fresh and exciting, but then again, that's what we thrive on. The DayOne team began its second year of operations finding ways to trim overhead, enhance the customer experience, and refine the retail operations. To further this effort, Andrew tapped New York–based Stephen Cooper—an expert in retailing and finance—to serve as the company's Chief Operating Officer. By early summer, the company—which in May had been honored with a “Best of SF” accolade (see Exhibit 9.5)—was signing up a steady stream of new members. Many of those clients were now being referred to the facility by local physicians who were quietly ignoring the sentiments of their hospital administrators. One such referral was Lisa Zoener, a new mom who said that she found out about DayOne from her obstetrician: I have told lots of people about this place; it's definitely a word of mouth type of thing. My husband and I drop a ton of dough here on baby vitamins and other stuff. DayOne products are definitely higher priced than in other stores, but I'm already here for the classes—and a lot of us feel that buying DayOne products is a way to support what they're trying to do here. I don't find the second floor to be a problem—there is a parking garage right downstairs. It was full today, though. EXHIBIT 9.5 SF Weekly Best of 2002 Feature Although he now had actual operating figures, a slew of customer testimonials, and an appropriate town picked out for the second DayOne, Andrew was still unable to raise the money he would need to proceed with those expansion plans. Then, in November, Andrew received a call that he was sure would change everything. The Saudi Connection Unknown to the DayOne staff, one of their very satisfied new moms was the daughter of a Saudi prince. Her father, Samir, was visiting from his home in London and, through her experience, had learned a lot about what DayOne was doing. Andrew described their two-hour meeting at the center: Samir said that he had an eye for businesses and that he thought what we were doing was brilliant. He said that he was the president of a multinational conglomerate out of London and Saudi Arabia; he wanted to fund our U.S. rollout and also help us export it to other countries. Andrew sent the prince on his way with a detailed business plan. Due diligence indicated that Samir was indeed who he said he was, so Andrew's excitement grew when the Saudi called a week later to say that he wanted to take it to the next level. That next step was having a colleague of his—a woman based in Arizona who had run four different billion-dollar retail businesses—work as his eyes and ears to determine the best way to move the venture forward. Ann Pearson, 60, a self-described workaholic and leading advisor to a separate $5-billion new venture fund, spent the entire day at the center and was thrilled with the concept. She explained that to move ahead, she and Andrew would need to build a business plan that would warrant her stamp of approval. Andrew recalled that that's when the real work began: For the next three months, Ann was flying here every few weeks, and Steve, our COO, was flying in from New York for three days at a time. She had us rewrite an entirely new business plan to sort of grind down to the nitty-gritty every aspect of the business so that she felt that she could put her stamp on it. We spent hundreds of hours, many tens of thousands of dollars. She was like this manic corporate raider–type, driving us really hard. Along the way, Andrew had begun to notice that Ann didn't seem to have a high regard for his DayOne staff and kept implying that, before the business could begin its rollout, management changes would have to be discussed. It was bad enough when she suggested that Samir's daughter—a junior investment banker—might make a good choice for CFO, but when Ann began to infer that Andrew might not make the cut as CEO, he'd heard enough: We had gotten into these heavy negotiations, and we had also started getting into huge fights. Ann ended up being an absolute animal; she wanted to drive everyone out of the business and take it over. But if you know me, I am not somebody who is going to get pushed around like that, and I wasn't going to sell out for anything. Then, all of a sudden, Samir calls and says that he's not interested anymore. It was nearly mid-spring of 2003 by the time Andrew turned away from that mirage—and several more months before the next major investor prospect would surface. The DayOne team now had a positive operating income for the center (see Exhibit 9.6), a detailed business plan with five-year pro-formas (see Exhibits 9.7–9.10), proven managerial performance, and, as always, a need for investment capital. EXHIBIT 9.6 DayOne Income Statement—San Francisco Actuals 2001 2002 2003 Retail Sales Product Sales $ 533,676 $687,492 $816,000 Memberships 55,566 62,774 76,050 Total Retail Sales $589,242 $750,266 $892,050 Total Service Sales 181,761 222,947 272,000 TOTAL SALES 771,003 973,213 1,164,050 Total Cost of Retail Sales 288,569 346,213 434,627 Total Cost of Service Sales 196,144 156,680 190,624 TOTAL COST OF SALES 484,713 502,893 625,251 Gross Margin Retail Sales 300,673 404,053 457,423 Percent of Sales 51.0% 53.9% 51.3% Gross Margin Service Sales (14,383) 66,267 81,376 Percent of Sales −1.9% 29.7% 29.9% TOTAL GROSS MARGIN 286,290 470,320 538,799 Percent of Sales 37.1% 48.3% 46.3% TOTAL CENTER EXPENSES 426,134 374,684 417,852 CENTER EBITDA (139,844) 95,636 120,947 Percent of Sales −18.1% 9.8% 10.4% EXHIBIT 9.7 Five-Year Income Statement Projections—Rollout Year 1 Year 2 Year 3 Year 4 Year 5 Total Stores 2 6 14 26 42 New Stores 2 4 8 12 16 RETAIL SALES Product Sales $1,904,000 $3,581,614 $10,713,896 $24,506,943 $46,011,931 Memberships 201,050 398,000 1,226,000 2,804,000 5,282,000 Total Retail Sales 2,105,050 3,979,614 11,939,896 27,310,943 51,293,931 Total Service Sales 647,000 1,250,800 3,713,000 8,470,000 15,882,000 TOTAL SALES 2,752,050 5,230,414 15,652,896 35,780,943 67,175,931 COST OF SALES Total Cost of Retail Sales 1,025,629 1,913,567 5,785,809 13,276,595 24,956,361 Total Cost of Service Sales 393,484 623,048 1,694,132 3,735,912 6,859,763 TOTAL COST OF SALES 1,419,113 2,536,615 7,479,941 17,012,507 31,816,124 GROSS MARGIN Gross Margin Retail Sales 1,079,421 2,066,047 6,154,087 14,034,348 26,337,570 Percent of Sales Gross 51.3% 51.9% 51.5% 51.4% 51.3% Margin Service Sales 253,516 627,752 2,018,868 4,734,088 9,022,237 Percent of Sales 39.2% 50.2% 54.4% 55.9% 56.8% TOTAL GROSS MARGIN 1,332,937 2,693,800 8,172,956 18,768,436 35,359,807 TOTAL CENTER EXPENSES 1,011,450 1,752,576 4,762,754 10,787,758 20,177,895 CENTER EBITDA 321,486 941,224 3,410,202 7,980,678 15,181,913 EXHIBIT 9.8 Five-Year Cash Flow Projections—Rollout Year 1 Year 2 Year 3 Year 4 Year 5 Operating Activities Net Income (974,692) (592,920) 971,764 4,522,301 11,111,776 Adjustments for Non-Cash Items FFE — — — — — Leasehold 102,857 308,571 720,000 1,337,143 2,160,000 Pre-Opening Costs 18,571 55,714 130,000 241,429 390,000 Product Promotions Total Adjustments for Non-Cash Items 121,429 364,286 850,000 1,578,571 2,550,000 Changes in Working Capital — — — — — Current Assets — — — — — Current Liabilities (312,188) — — — — Net Changes in Working Capital (312,188) — — — — Net Cash—Operating Activities (1,165,452) (228,634) 1,821,764 6,100,873 13,661,776 Investing Activities Investing Activities — — — — — FFE (720,000) (1,440,000) (2,880,000) (4,320,000) (5,760,000) Leasehold (130,000) (260,000) (520,000) (780,000) (1,040,000) Pre-Opening Costs (300,000) (600,000) (1,200,000) (1,800,000) (2,400,000) Inventory (120,000) (240,000) (160,000) (240,000) (320,000) Security Deposits Net Cash—Investing Activities (1,270,000) (2,540,000) (4,760,000) (7,140,000) (9,520,000) Financing Activities Proceeds from Class B Unit Offering — — — — — Founder Investment — — — — — Payments on Notes Payable and LT Debt (624,758) — — — — Common Stock Repurchases — — — — — Proceeds from Exercised Stock Options — — — — — Net Increase (Decrease) in Short-Term Debt — — — — — Net Cash—Financing Activities (624,758) Inc/(Dec) in Cash Equivalents (3,060,210) (2,768,634) (2,938,236) (1,039,127) 4,141,776 Cash and Equivalents Beginning Balance 7,232 (3,052,978) (5,821,612) (8,759,847) (9,798,975) Cash and Equivalents at Ending balance (3,052,978) (5,821,612) (8,759,847) (9,798,975) (5,657,199) EXHIBIT 9.9 Five-Year Balance Sheet Projections—Rollout Year 1 Year 2 Year 3 Year 4 Year 5 Total Stores 2 6 14 26 42 New Stores 2 4 8 12 16 ASSETS Cash $ (2,632,978) $ (4,621,612) $ (5,994,847) $ (5,093,975) $  1,257,801 Other Current Assets $  25,316 $ 25,316 $ 25,316 $ 25,316 $ 25,316 Total Current Assets (2,607,662) (4,596,296) (5,969,531) (5,068,659) 1,283,117 Inventory 416,516 1,016,516 2,216,516 4,016,516 6,416,516 Fixed Assets Leasehold 1,352,424 2,792,424 5,672,424 9,992,424 15,752,424 Accumulated Depreciation (102,857) (411,429) (1,131,429) (2,468,571) (4,628,571) Net Leasehold 1,249,567 2,380,995 4,540,995 7,523,853 11,123,853 Security Deposit 172,000 412,000 572,000 812,000 1,132,000 Pre-Opening Expenses 130,000 390,000 910,000 1,690,000 2,730,000 Accumulated Depreciation (18,571) (74,286) (204,286) (445,714) (835,714) Net Pre-Opening Expenses 111,429 315,714 705,714 1,244,286 1,894,286 Total Fixed Assets 1,532,995 3,108,710 5,818,710 9,580,138 14,150,138 TOTAL ASSETS $  (658,150) $  (471,070) $ 2,065,694 $ 8,527,996 $21,849,772 LIABILITIES Short-Term Liabilities Trade Payables — — — — — Trade—Zenoff Products — — — — — Van—Note Payable — — — — — Other Payables 13,806 13,806 13,806 13,806 13,806 Total Current Liabilities 13,806 13,806 13,806 13,806 13,806 Long-Term Liabilities — Accrued Compensation Notes Payable — Total Long-Term Liabilities — — — — — TOTAL LIABILITIES 13,806 13,806 13,806 13,806 13,806 EQUITY Retained Earnings—Prior Year (1,454,355) (2,009,048) (1,821,967) 714,797 7,177,099 Retained Earnings—Current Year (554,692) 187,080 2,536,764 6,462,301 13,321,776 Additional Paid-In Capital 1,064,304 1,064,304 1,064,304 1,064,304 1,064,304 Partnership Earn/(Loss) 272,787 272,787 272,787 272,787 272,787 Total Equity (671,957) (484,876) 2,051,888 8,514,190 21,835,965 TOTAL LIABILITIES AND EQUITY $  (658,151) $  (471,070) $  2,065,694 $  8,527,996 $ 21,849,771 EXHIBIT 9.10 Five-Year Corporate Year 1 Year 2 Year 3 Year 4 Year 5 Executive CEO 175,000 175,000 200,000 200,000 200,000 Chairman 150,000 150,000 150,000 COO 150,000 175,000 200,000 200,000 200,000 CFO 75,000 100,000 125,000 150,000 150,000 Office and Finance Controller 90,000 90,000 90,000 Finance Clerk 85,000 40,000 40,000 40,000 IT Manager 85,000 85,000 85,000 Inventory Manager 85,000 85,000 85,000 Office Clerk 40,000 40,000 40,000 40,000 40,000 Office Clerk 40,000 40,000 40,000 Service Service Director 45,000 95,000 100,000 200,000 200,000 Service Manager 75,000 150,000 Service Assistant 40,000 80,000 80,000 Marketing Marketing Director 100,000 125,000 125,000 125,000 Marketing Assistant 45,000 80,000 80,000 Operations Operations Director 100,000 100,000 100,000 Operations Manager 60,000 60,000 120,000 180,000 Operations Assistant 40,000 40,000 40,000 Operations Assistant 40,000 40,000 Operations Assistant 40,000 Purchasing Buyer 60,000 60,000 120,000 Assistant Buyer 40,000 80,000 120,000 Total Salaries 485,000 830,000 1,665,000 2,090,000 2,410,000 Benefits Load (15%) 557,750 954,500 1,914,750 2,403,500 2,771,500 Increase (2%) 11,155 19,090 38,295 48,070 Total Corporate Payroll 1,042,750 1,795,655 3,598,840 4,531,795 5,229,570 Prove It—Again The DayOne plan called for opening 42 centers in five years, but so far the team found itself in a holding pattern around its flagship location. Andrew thought it ironic that, by overcoming challenges and making compromises to get the first store open, they had developed a business that investors seemed unwilling to accept as a proof of concept: We are now one of the most trusted brands in San Francisco. People love us. Investors are saying, well, this first center has done great for what it is, but your plan talks about a center that would be on the ground floor with street-side visibility, have support from the hospitals, and be in a bigger, more appropriate space. So because we are talking about a bigger center with bigger economics, they don't want to take the risks. Andrew estimated that he was going to need about $1.3 million to pay off current debt and open up a center that was more reflective of the business plan model (see Exhibit 9.11). That second DayOne would be sited in an affluent town about 35 miles to the south: Palo Alto would be the next spot. It's in our back yard, and it's got the right demographics. It would be a bigger center, with more space, twice as many classrooms; twice the business, twice the sales. EXHIBIT 9.11 Typical Center—Development Budget PRE-OPENING COSTS Store Build-Out (˜3,800 sq. ft.) 418,000 6 Months Management Salary 110,000 Pre-Opening Expenses 65,000 Operations Consultant—Travel 10,000 Operations Consultant 30,000 Real Estate Acquisition 10,000 Inventory 155,000 Security Deposit 40,000 Miscellaneous 50,000 Total Pre-Opening Costs 888,000 CORPORATE OVERHEAD Legal, Acctg, Other Prof Fees 15,000 Payroll and Benefits 225,000 FFE 10,000 Insurance 20,000 Utilities & Rent/Whse 12,000 Miscellaneous 20,000 Total Corporate Overhead 302,000 TOTAL CASH REQUIREMENTS 1,190,000 Sallie noted that, because of the rave reviews her group had received, some investors wondered aloud if that magic could be replicated in other centers: We have a great reputation in the community, and we set a tone here of warmth; we respect these women. Can we find as good a staff for Palo Alto, and can we train them well enough? Absolutely. Sure, it won't ever be what we have here, but it doesn't have to be to make the business work. I have no doubt that in every community we choose to locate in we can find qualified, caring nurses who would love the chance to do what we are doing here. She paused—and then added: We hit bumps, and then we move on. And all the while we keep refining this model; the quality of our workshops, the way we work; it's all so much better than it was even one year ago. So it will happen; I'm sure of it—this struggle is for a reason. Andrew is big on that; it's all about the journey, not the destination. Moving Forward Andrew checked his cash-on-hand balance. After three years, he had still not taken a dime of salary, and yet he had to smile as he penned this particular company check. The cabinetry work at the facility had cost $85,000, and with this disbursement, Andrew would be making good on his promise to pay those guys—not quickly—but in full. There were plenty of others who were still waiting, but in time, they would be paid as well. The phone rang, and on the other end was a young venture capitalist whose partner's pregnant wife had heard about DayOne from her sister's friend's pediatrician…. Preparation Questions What more can the members of the DayOne team do to build credibility and improve their chances of securing the capital they need to implement the business plan? What other options might be considered for raising the funds needed to move the company ahead? Imagine Andrew has approached you as a potential investor. Has DayOne proven the model yet? What are your concerns? Would you invest?