The Language of Business

By

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The language of business is finance. For every ten words, you need one number. If you don't, you'll easily get fluffy. This notion rings true not only for listed corporations; it is just as valid for startups. I see many investor pitch decks that are impressive in their vision and the way that their innovative product solves a real problem. But often, the story falls flat when it comes to the numbers. When I say numbers, I am not just talking about the financial projections and forecasts. Investors are very sceptical of those anyway. What is more important is to display a deep understanding of your own business model, the dynamics of your model, and the key metrics in your model that drive the financial performance of your business. In other words: your **business model economics**.

A good starting point to understand business model economics is to first understand the concept of a business model. Many pitch decks have a slide titled 'Business Model' that merely show pricing. In reality, your business model is not just your pricing. This is explained really well in the book "Business Model Generation". This popular book does a great job explaining all the key components of your business model, and how they relate and interact to drive specific dynamics. It provides the tools to help define, refine, and communicate your business model, which you can then leverage to start better understanding its economics, i.e. the key metrics that drive your model.

In the New York Times bestseller "The Lean Startup", Eric Ries talks about Vanity Metrics. These are metrics that looks impressive, but tell you little about your business, and are not relevant in driving the financial performance of your business. But how to know which metrics are vanity and which are essential? It all depends on the economics of your business model.

Let me give you an example. I have worked with an entrepreneur who is building a powerful Cloud-based social learning platform in India. He was carefully looking at a wide range of metrics and focused on '# of page views'. But, when he looked closer, he realized this metric wasn't driving up volume or price, so there was no impact on revenue. It wasn't driving down cost either, so there was no impact on profitability. In his business model, page views were nothing more than a vanity metric. He soon found that what really mattered in his business model was the number of 'learning actions' that the visitors performed on the platform. This metric soon became the key focus for their customer acquisition strategy and user engagement strategy. The outcome: more value for the customer, leading to a higher willingness to pay, a higher price, and increased revenue.

Business Model Economics for Start Ups

As explained previously, it is the numbers that count. It is the business model economics that decide whether the business is viable. Hence, it is crucial to carefully define and communicate your business model, and then analyze the model and identify the key ratios and metrics that drive the dynamics and outcomes of your business model.

"In order to assess a potential business model, entrepreneurs must uncover the nature of its 'profit engine' which is often obscured by ambitious financial and market projections. Entrepreneurs must ask themselves whether their business concept can be translated into a viable, profitable business venture and how much cash it will take to achieve that result."

This quote is taken from an article entitled "**Note on Business Model Analysis for the Entrepreneur**", published by Harvard Business School in January 2002. The article explains how business model analysis should focus on 4 key areas:

- **Revenue Sources** – identify the key revenue streams and the size and importance of the different revenue resources, then disaggregate the revenue data to uncover the key revenue drivers
- **Cost Drivers** – identify the cost components that have the greatest impact on your cost structure, then disaggregate the cost data to uncover the key cost drivers
- **Critical Success Factors** – identify the key drivers and metrics that are most important to achieving your profit goals
- **Investment Size** – identify how much cash is needed to launch the business and how much working capital is needed to sustain the business, then determine the total investment size to achieve positive cash flow

While not necessarily easy, this approach to business model analysis will deliver some significant benefits for you and your business. It will help to:

1. Quantify the viability of your business model, decide when to correct the course and take appropriate actions.
2. Develop an understanding of the key drivers and metrics that influence your business so you can develop specific, targeted strategies
3. Raise funds by giving you better insights into the activities and resources required to be successful, and understand how much cash is needed to get to profitability.

It also enables you to demonstrate to investors that you truly know your business and what is needed to be successful. Ultimately, that is what gives them confidence that you are worth investing in.

How does this approach to business model economics fit into your overall strategy and business plan? Here's a flow that I observe that has worked well: you still start with the problem you are solving and the way your product or service solves this problem in a unique and compelling way. You then look at the business model: what is your value proposition, who is your target market, what is your "Go to Market" strategy, and how do you generate revenue and profit. From there, it is a logical step to start the business model analysis as explained above and identify the revenue sources, costs components and the key drivers that impact both of these. The next step is to ensure that your growth strategy and Goto Market activities are specifically focused on these critical areas and targeted to drive the identified metrics in the right direction. Finally, you can identify how much cash is needed to execute your strategy and perform the activities to break even.

Investors rarely believe the financial projections that startups show them. What they do believe, however, are smart entrepreneurs who have a thorough understanding of their business and combine an innovative product with solid business model economics. So for both the investor and the entrepreneur, it is the numbers that count.

About Pieter Kemps

Pieter works for Amazon Web Services and interacts closely with leading VC's and fast growing tech startups in Asia. He is passionate about startups that combine product innovation with strong business model economics. Amazon Web Services is a Supporting Sponsor at Echelon 2012.

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