What every big corporation should know about start-ups

'Start-up' is a term typically used to describe a company that is less than 10 years old with less than 50 employees. They can be classified in many ways, but two of the most common views are in terms of the type of business model they are applying and the funding they have received or generated to date.

Business model

There are a number of business models that a start-up may be using, or planning to use, to generate revenue from a technology. Business models for a start-up can typically be grouped as follows:

- Sell the technology outright – the start-up is seeking to get a one-off payment for its technology.
- License the technology – either on an exclusive or non-exclusive basis.
- Sub-contract elements of the value-creation activities to others – e.g., product development, production, marketing, sales and support, etc.
- Manage all the value-creation activities in-house – becoming more unusual, but some start-ups do pursue this route.

An alternative way of looking at the business model is in terms of what is being sold. This may encompass selling a:

- Technology
- Product
- Solution
- Service only
- Service enabled by a product
- Product plus consumables
- Product plus accessories

The business model selected by a start-up can also be viewed as sitting on a continuum from 'soft' (consultancy-based) to 'hard' (product-based).

The choice of business model selected by a start-up is dependent upon many factors including:

- **The strategy of the founders**: Do they want to build a business for the long term, or do they want to focus on short term wealth generation?
- **The nature of the technology**: Does it require substantial further development, or is it at a high level of technology readiness for a specific application?
- **The resources available to the firm**: If investors are not interested in supporting the firm, they will need to select a business model that gets them to revenue generation as quickly as possible

These factors are unlikely to remain constant, and so one common feature of start-ups is that their business model may change significantly, rapidly and frequently. This flexibility resulting from an absence of 'baggage' associated with a long history is one of the core strengths of a start-up. It does, however, present challenges when forming partnerships with less flexible organisations.

Funding stage

Start-ups will not have a long history of revenue generation and hence retained profits which can be applied to develop new products and services. They need to acquire funding from external providers to implement their chosen business model. These funding providers can be categorised in the **type** of funding, and **stage** of company growth to which they target their funding.

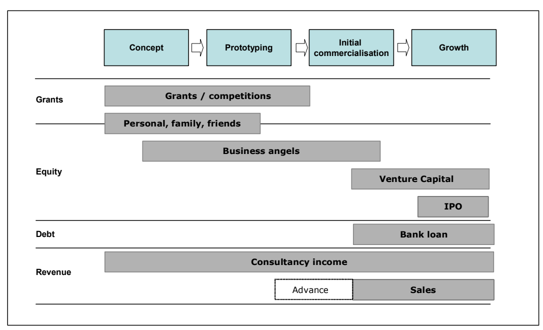

Figure 1: Types of funding and stage of start-up

The start-up management team – especially those that are pursing a 'hard' business model – are likely to spend a significant amount of their time either seeking funding, or managing relationships with their funders. This will be a priority for the start-up as, especially in the early stages of its growth, it has no revenue. It therefore needs external funding as without cash, the company cannot survive (hence the often quoted mantra used by start-ups

'CFIMITYM'[1]). The cash balance of a typical product-based start-up is often characterised by a j-shaped (or 'hockey-stick') curve, illustrating the amount of investment they need to keep the company afloat until sufficient income is generated by sales.

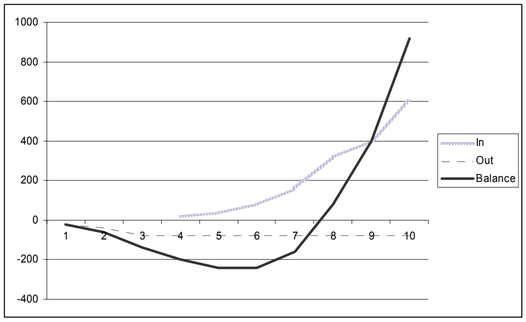

Figure 2: Typical cash flow for start-up seeking investment

The cash position of the start-up may have a significant impact upon the approach taken to setting up partnerships with large firms. If the start-up is near the end of its existing cash reserves, and is not yet getting significant revenue from customers, it may be keen to reach agreement quickly. If, however, it has a strong cash position, it may be able to spend more time setting-up and developing partnerships.

For those firms that are seeking venture capital backing (and this is a minority of all technology-based start-ups), their stages of development are closely tied to the specific stages of venture capital investment (see Figure 3).

From: www.chilli.com

S1 (seed stage 1)
A company or an individual who has developed a concept and carried out preliminary market research, which needs S1 funding to develop an effective business plan, and register the company.

S2 (seed stage 2)
A company that has researched and developed an initial business plan, and needs S2 funding to create a model or a demonstrator (but not a working prototype yet), validate the business plan with detailed financial analysis, identify the founding team (but not recruited yet), and research and prepare (but not file) key patents.
Chilli S3 (seed stage 3)

A company that has validated its business, product or service strategy with one or two prospective customers by successfully demonstrating a model and needs S3 funding to fully develop a working or functional prototype, recruit one or two additional team members or pay subcontractors, and file the initial paperwork for key patents. The company will have also started but not fully engaged external corporate finance and legal advisors in order to prepare for the first round VC funding.

R1 (round 1 - series A)
A company that has successfully demonstrated its model or prototype to potential customers, partners, and needs R1 funding (and issue series A preferred convertible shares in return) to fully develop the product or service, which can be delivered to pilot customers for sampling, evaluation and design-in. The R1 funding will pay for the required infrastructure like lab, capital equipment, tools and facilities including the personnel cost of the core team and sub-contractors. The R1 funding should be sufficient to pay for minimum sales, marketing and finance/admin personnel, to facilitate the agreed R1 milestones such as signed number of pilot customers, partners, number of staff and patents. The company may generate some nominal revenue from its pilot activities.

R2 (round 2 - series B)
A company that has successfully developed its first product and/or service and acquired the first few pilot customers and partners. R2 funding is required to convince more potential customers, that sufficient capital is available to fulfill the terms of the orders or contracts. R2 funding will also allow the company to expand its sales, marketing, customer support, finance and admin personnel, as well as expand its markets, products and services. R2 funding is intended to allow the company to reach a break-even position and achieve a critical mass of customers and market presence.

R3 (round 3 - series C)
A company that has reached a critical stage with its products, services, customers, and market presence and needs R3 funding to consolidate its resources and market presence. R3 funding will allow a company to make a potential acquisition and/or seek merger with a bigger organisation, or alternatively position itself for a successful exit via trade sale or initial public offering (IPO) via listing on a recognised share exchange such as the LSE or NASDAQ.

Figure 3: Funding stages for VC-backed start-up[2]

Reasons for working with large companies

For a start-up, being typically resource-poor but idea rich, the logic of working with a large firm is very clear as it may provide access to a wide range of benefits from the tangible (e.g., access to production equipment) to the intangible (e.g., increasing the credibility of the start-up by association with a trusted, established brand). The partnership may be based around something very specific (e.g. joint development of a particular technology) to the broadly defined (e.g., to take an option on future technological developments). The partnership may have an intentionally short term life (the 'fruit fly' or 'transitory' partnership) or may be a long term strategic alliance – and its function may change over time.

However benefits from partnerships are not easily accessible to the start-up without cost. Often the main cost is the high level of management time - a very precious resources in a small firm - that needs to be devoted over a long period of time to making a partnership work.

Tim Minshall, Letizia Mortara & Pete Fraser, 2006.

[1] 'Cash Flow Is More Important Than Your Mother'.

[2] www.chilli.com