Business Model Validation

Business Model Validation Report

ABC Corporation

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Business Model Validation

Date of Report

July 24, 2013

Conclusion

The Business Model of ABC Corporation is Validated.
See full report for related analysis and disclaimers.

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USE OF THIS REPORT

This report was prepared on July 24, 2013 and is valid only as of that date.

In preparing this report, we relied on information that we believed to be reliable but we did not fact-check every piece of information that came under our review.

Subsequent events may have transpired that effect the subject company's business model.

Even in the event that we validated a business model as of the aforementioned date, such validation does not guarantee that the subject company will reach every one of its—or its stakeholders'—milestones or expectations. Events beyond management's control may affect the execution of a company's business model.

Before making investment or business decisions, readers must undertake their own research and make their own assessments of the subject company's business model, investment worthiness and future outlook. Those wishing to invest in—or transact business with—the subject company must retain their own subject matter experts to assist them in making such investment and business decisions.

Neither Business Model Validation nor its analysts or affiliates assume any responsibility for any adverse results of investing in—or transacting business with—the subject company.

METHODOLOGY

For more than 20 years, we have been valuing and assessing companies. We have analyzed and reviewed hundreds of business models and business / strategic plans. From this experience—and as can be reviewed on the pages that follow—we have compiled a list of over 300 questions that address many facets of business models.

It is with these and many other considerations in mind, that we begin assessing the subject business model by reviewing the relevant business plans, white papers, presentations, brochures, spec sheets and accompanying financial models. The review of these documents is complemented by research into the relevant industry. This industry research is both primary (e.g. interviews with industry experts such as former industry executives, trade association representatives, industry reporters, etc.) as well as secondary (e.g. Internet research and the review of other analyst reports.) Then, we interview the management team. We synthesize our review of company documents, our independent research as well as insight gleaned from interviews with management. Ideally (and to the extent practical) we like to conduct live, on-site interviews with CEOs and CFOs as well as Directors of Business Development, Research & Development, Manufacturing, and Marketing.

In determining whether the subject business model is deserving of the Business Model Validation imprimatur, we employee both analytical assessments and subjective reasoning. We believe that penetrating business models requires data driven analysis as well as the mental dexterity that results from many years of experience reviewing business challenges throughout a diverse array of industries.

Developing highly granular financial models without considering the human element of execution is an exercise in futility. Implementing business plans without subjecting them to numerical scrutiny is a gamble, not a strategy.

When reviewing business models, we dedicate both hemispheres of our brains. Our analysis is a unique combination of calculation and judgment.

EXECUTIVE SUMMARY

The ABC Corporation plans to launch an online expense management platform within the next three months. The expenses to be managed include the meals, catering, car service, printing, temporary help and similar services that are purchased by professional service firms such as law firms, accounting firms, architect firms, advertising agencies and other similar organizations.

ABC's key selling proposition is that it will enable such clients to track and integrate such expenditures into the appropriate client matter accounts at the point of placing an order for the selected services. Should the roll-out of this service prove successful, ABC stands to generate revenue from the professional service firms by charging commissions from restaurants, car service providers and print shops that receive order flow from ABC. ABC's service could expand virally as controllers, CFOs and office managers could enforce the use of ABC's website to place such orders so as to receive the benefits of related charges being automatically posted to the appropriate client account and client matter numbers.

Among the aspects of ABC's business model that I find most attractive are:

- Compelling customer proposition. It has been estimated that professional service firms lose between $400 million and $500 million annually in not properly accounting for expenses that should be presented to clients for payment. Further, professional service firms spend tremendous resources on verifying and paying invoices from the dozens of restaurants and the like that they purchase from. ABC's expense management software can greatly reduce these inefficiencies experienced by professional service firms.

- Enforced network effects. I believe that clients that begin using ABC's website to place orders, such practices will usually be enforced office-wide. This is because clients' controllers and bookkeepers will find it more efficient to have all employees avail themselves of ABC's ordering system. Establishing a beachhead at one client office could result in more offices in different cities wishing to use ABC's ordering system. Thus, penetrating additional geographic markets could be more expedient.

- Proven business model. While the success of Seamless Web in New York City eliminates ABC's ability to serve that geographic market, it demonstrates to potential ABC clients that the business model is embraced by many of their peers. This fact should reduce the amount of missionary selling required on the part of ABC.

- Limited marketing required. ABC is relieved from the necessity of launching expensive retail marketing campaigns. Rather, it can limit it marketing and sales efforts to key decision makers—controllers, CFOs, etc. –at targeted companies.

- Cohesive and complimentary management team. Members of senior management have been friends for as long as 15 years and have worked together for as long as four years. One member of management resigned from a well-paying position at a very reputable company to join ABC and another member of management related to join ABC.

- Promising market penetration strategy. I like ABC's (geographic) market entry strategy, particularly its plan to have Advisory Boards in each city it enters. The Advisory Boards will consist of senior business leaders in the community that generate large billings among the various city's professional service firms. The renown of these business leaders should be sufficient ammunition for the telesales team to set up initial meetings / product demonstrations.

- Management's focus. While the ABC management team is young and is full of energy, they are also extremely focused. Instead of pursuing the development of online apps, entering an excessive number of markets on initial rollout and signing up an unnecessarily diverse range of service providers, ABC is focused on providing a Minimally Viable Product in the most promising markets. The management team will learn from its launch and tweak its model accordingly.

- No key employee issues. Once ABC's service is up and running, the Company should be able to staff its operations with relatively low-cost employees. The learning curves for adeptly handling various positions—such as telesales, customer support, running demonstrations, liaising with service providers, etc.—should be very rapid. I do not envision that the Company will be vulnerable to any significant employee ransoms.

- Low capital intensity. The Company's recent $3 million capital raise should be sufficient to launch the company. Post launch, the ongoing burn rate should be at most $150,000 per month. Breakeven should be achieved in 15 months.

- Simple accounting. I believe that the risk of any accounting irregularities is extremely small. I cannot understand how there can be any related party transactions risks. There is no vendor financing, off-balance sheet entities or currency risks. There is substantially no use of cash in ABC's business model.

- Hygienic capital structure. ABC was self-funded by its founders until its recent Series A venture capital raise. The Company has not raised any capital from angel investors and has no convertible notes outstanding. This streamlined capital structure removes risks associated with converting notes into preferred stock as well as with issues related to valuation caps placed on convertible notes.

- Positive working capital. I anticipate that ABC will enjoy positive working capital as its receipt of inflows from clients is contractually stipulated to occur at the end of each month and restaurants will receive their payments from ABC within 60 to 90 days. (These contractual arrangements notwithstanding, it is not certain that ABC's clients will always actually make remittances on time.)

- Positive stakeholder alignment. I believe that the venture capitalists that invested $3 million in ABC share the same expectations for growth and profitability and potential exit scenarios with ABC's management.

Nevertheless, the following are among our chief concerns:

- Key markets are already saturated with similar expense tracking / online ordering systems. Seamless Web's position in the New York City market, for instance, is impenetrable. Since, in my opinion, ABC will never be able to displace entrenched competitors in several of the largest North American markets, ABC will have to launch in smaller markets.

- While ABC's ordering / expense management system renders billing more efficient, ABC does not address a pain point that that is excruciating for targeted clients. Moreover, some of the individuals involved in making decisions relative using ABC's website may have self-serving reasons to elect not to deploy ABC at their organizations. Specifically, some accounts payables people may relish existing inefficiencies so as to solidify their employment.

- I disagree with ABC's idea of waiving commissions to be charged to its professional service firm clients. This decision will eliminate one lucrative revenue stream. I also fear that potential clients will refrain from becoming customers as they will not want to transact business with a company that could be perceived as having an unsustainable business model. I urge to ABC to implement some fees on clients. If not commissions on each order that they place, then at least a set-up fee or license. In addition to these measures delivering more revenues, they will help in prospecting (if potential clients balk at such fees, perhaps sales efforts should be directed elsewhere).

- Failure to execute on the part of channel partners could reflect poorly on ABC. For instance, if a restaurant fails to deliver two items ordered or if the order is delivered late, if ABC fails to impress upon its customers that ABC is merely the ordering media (the delivery of the service is solely the domain of the service provider), ABC could be bombarded by complaints and its reputation tarnished.

- ABC could be exposed to the Icarus Paradox. That is, once companies begin using ABC's service, they will be able to better track their expenditures on food, printing, car service and the like. These expenses could become more visible to management and management may make efforts to reduce such costs, which would therefore reduce the ability of ABC to generate commissions.

Conclusion

No business model is beyond critiquing or concern. However, I reviewed the business model of ABC Corporation and it is my belief that—as of July 24, 2013—its Business Model merits validation.

Industry Analysis

- How intense is the industry competition?
- How are the industry leaders doing?
- What proposed regulations and laws could impact the industry?
- Are industries that produce substitutes becoming more or less competitive?
- How much missionary selling is necessary?
- Is the possible entrance of dominant competitors welcomed or feared?
- How much leverage does the company have with its suppliers?
- How much leverage does the company have with its distributors?
- How much leverage does the company have with its customers?

Summary of Analysis

ABC faces competition from established accounting management software products (some offered by very large companies such as Oracle, SAS, and IBM) and inertia (choosing the status quo) on the part of its clients. The larger metropolitan markets in the United States are already served by dominant companies (such as Seamless Web) with a similar business model. Those markets will not be candidates for ABC. In the markets that ABC seeks to serve, there is no direct competition from companies unleashing similar business models.

However, it is questionable as to how lucrative such markets may be. There are fewer professional service firms in second and third tier cities and these professionals may consume fewer meals and the like than their peers in larger cities. For instance, the closings for acquisitions or commercial real estate transactions are more likely to take place in a large city (thereby necessitating the ordering of ample catering) than in a smaller town. Restaurants are less likely to offer delivery to service professionals outside of normal working hours.

Also of concern is whether critical mass can be achieved. While many large cities are familiar with the type of services ABC plans to launch, more missionary selling will be required in smaller towns. In large markets such as New York City, if some restaurants refrain from registering with ABC, there are many other candidates. However, in smaller markets, failing to secure several reputable restaurants (or even reputable restaurants in important categories (such as Italian or Japanese food)) could call into question ABCs legitimacy.

There has been a proliferation of businesses focusing on the hyper-local market and there is fatigue from this phenomenon. The fatigue on the part of businesses being exposed to too many hyper-local pitches could make the selling of the concept more difficult.

In analogs considered, restaurants and other service providers are receptive to registering with businesses such as ABC. They view the 10% to 15% commission payable to ABC as well worth the marketing and order flow that companies such as ABC provide. When critical mass is achieved, restaurants and other targeted service providers feel that they would be at a competitive disadvantage by not affiliating with an ABC-type business. Who doesn't want to be listed on a popular ordering media?

There are no specific regulations that could adversely help or hinder the ABC business model.

Corporate Structure Considerations

- In which legal entity is the business held? What are the associated advantages and disadvantages?
- In which legal jurisdiction is the legal entity registered? What are the associated advantages and disadvantages?
- Where is the business headquartered? What are the associated advantages and disadvantages?
- Who are shareholders and what percentages of the company do the different classes of shareholders own?
- What portion of the company's capital structure is funded by management? What sacrifices where made to raise such funds?
- Have any members of management or Board of Directors made any guarantees on debt received by the company?
- What is the breakdown between equity and debt?
- Do hedge funds own any equity or debt of the company?
- Are any restrictions in place that would restrict hedge funds from owning any equity or debt of the company?
- What should we understand about the equity shareholders?
- Do they own preferred shares?
- Have anti-dilution benefits?
- Liquidation preferences?
- Board representation?
- What should we understand about the creditors?

- What is the debt repayment schedule? What is the interest rate?
- Is any debt convertible into equity?
- If so, how much and at what conversion rates?
- What corporate transactions has the company undergone recently?
    - Capital raises?
    - Mergers?
    - Acquisitions?
    - Joint-ventures?
    - Divestitures?

Summary of Analysis

ABC is registered as a C corporation in Delaware, reflecting both traditional and legitimate decisions. The Company's headquarters are in Walnut Creek, California. While the Company is in close proximity to venture capital, it is not ideally located to the many of the markets that it wishes to serve. These markets are in the mid-West and servicing these markets requires on the ground presence. During the initial stages of scouting and attempting to enter selected markets, the Company will incur high travel-related costs. To build out selected markets, the Company will have to recruit onsite personnel to run operations. It is risky for start-up companies to make hiring decisions whereby the new hires will not be under the close supervision of the founders.

The Company has raised seed capital and Series A venture capital. I think the $12 million valuation on the A round was aggressive. Consequently, the milestones set for ABC are aggressive. If these milestones are not met, founders could suffer dilution. Such dilution could demotivate management. The venture capitalists have 1.5 times liquidation preferences and some anti-dilution privileges.

ABC has not been party to any corporate transactions.

REMAINDER OF ANALYSIS – INTENTIONALLY DELETED

Marketing Considerations

- How many segments are you marketing to?
- What are the synergies among these marketing segments?
- How different / expensive are the associated marketing campaigns?
- Do your customers refer their friends to you?
- Are you winning customers via marketing or referrals?
- How does your cost of customer acquisition compare to lifetime customer value?
- Is the marketing budget coming out of cash flow / earnings or capital raises?
- What percentage of your customers only buy on promotional basis?

Summary of Analysis

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Accounting Considerations

- Are there any foreseeable accounting changes that could impact the company?
- Does the company or its competitors have vendor financing?
- Does the company have a history of changing its accounting policies?
- Does the company have a history of changing its accounting firms?
- Has there been turnover of the firm's CFO, controller or treasurer?
- When accounting for a new initiative, are you accounting for fixed costs in a preceding business line?
- How are other, large, public companies in the same space performing?
- What kind of accounting and internal controls does the company have in place?
- What is the likelihood of related party transactions?
- Is there any evidence of channel stuffing?
- Have any unusually large bonuses been paid to insiders in recent years?

Summary of Analysis

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Management Analysis

- How long has the core managerial team been together?
- What sacrifices did team members make to join the team?
- What level of relevant experience do the key managers have?
- Is the company hiring too rapidly?
- What is the turnover of employees?
- Is the company modeling in that new hires will be as motivated, dedicated, loyal as the founders?
- How are employees recruited?
- Are any of the key managers related to other employees or stakeholders?
- Is the CEO of the company also the Chairman of the Board of Directors?
- What are the qualifications on the members of your Board of Directors and Advisory Boards?

Summary of Analysis

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APPENDIX A

ASSUMPTIONS AND LIMITING CONDITIONS

1. Information, estimates, and opinions contained in this Business Model Validation are obtained from sources considered to be reliable. We have not independently verified every piece of data presented by management to us or that we located from external sources. We assume no liability for such sources.

2. Information supplied by management has been accepted as correct without further verification, and we express no opinion on that information.

3. Possession of this Business Model Validation, or copy or electronic version thereof, does not carry with it the right of publication of all or part of it, nor may it be used for any purpose by anyone but the client without the previous written consent of the client or us and, in any event, only with proper attribution.

4. This Business Model Validation may not be used outside of the context presented herein. Any validation of the subject business model are valid only for the purposes specified herein as of July 24, 2013. Subsequent events have not been considered, and we have no obligation to update this report for such events and conditions.

5. Neither the professionals who worked on this Business Model Validation nor the partners of IncreMental Advantage, LLC have any present or contemplated future interest in ABC Company nor have any interest that might prevent us from performing an unbiased recommendation. Our compensation is not contingent on an action or event resulting from the analyses, opinions, or conclusions in, or the use of, this memorandum.

6. The compensation we received from ABC Company is not contingent on deeming its business model as validated.

APPENDIX B

SOURCES OF INFORMATION RELIED UPON IN THIS BUSINESS MODEL VALIDATON

External Documents and Sources

1. Interviews with:
    a. Mr. Robert Jones, CEO of ABC Corporation
    b. Mr. Roger Jackson, VP – Business Development, ABC Corporation
    c. Ms. Kathy Williams, current customer of ABC Corporation

2. ABC Corporation's
    a. Business Plan
    b. Term Sheet with prospective venture capital investors
    c. Marketing material
    d. Financial models
    e. Customer reviews
    f. Press clippings
    g. Website

3. General Internet searches

4. Course materials used in the Certified Emerging Company Analyst training program

APPENDIX C
Curriculum Vitae of Lead Analyst
David Wanetick

Current Positions

IncreMental Advantage, LLC, Managing Director, Princeton, NJ Since 2005, David Wanetick has been a Managing Director at IncreMental Advantage, a valuation firm with an expertise in valuing intangible assets and emerging technologies. He is involved in all of the firm's valuation and business modeling. Clients include law firms; emerging, mid- and large-sized companies; technology transfer offices; inventors; venture capitalists and private equity firms. Valuations are primarily conducted in the context of negotiating licensing agreements, mergers and acquisitions and litigation support.

Business Model Validation Since 2009, David has been the CEO of Business Model Validation, a firm which develops and reviews sophisticated business models for purposes of raising capital and capital budget allocation.

Devil's Advocate Auditor Since 2009, David has been the CEO of Devil's Advocate Auditor. Devil's Advocate Auditors assess the merits of companies' business and strategic plans.

Certified Emerging Company Analyst David developed the Certified Emerging Company Analyst designation in 2012. The CECA curriculum provides an unbeatable repertoire of courses to help analysts and investors distill the value of emerging companies.

Certified Patent Valuation Analyst Since 2008, David has developed the curriculum and has run dozens of the courses required for applicants to earn their designations as Certified Patent Valuation Analysts. He works closely with other CPVA board members in terms of updating the course materials and updating the related exam.

Patent Fairness Opinions Since 2013, David has begun formalizing and standardizing the preparation of patent fairness opinions that are used in a wide array of patent-related transactions all over the world.

Previous Positions

Earlier in his career, David was a securities research analyst and was employed by Merrill Lynch, First Albany and wrote his own newsletter, Market Maneuvers. David was the senior analyst for Gateway Memorandums / the Wall Street Transcript for five years.

Previous Valuations

Among the specific technologies and companies that David Wanetick valued are semiconductor equipment; optical inspection; micro electrical mechanical systems; keyboard, video, mouse patents; SIM card technologies; Internet applications; water separation technologies; water carbonation technologies; RF communication links; Internet traffic control technologies; payment processing technologies; Internet search applications; biometrics; electro-magnetic pulse inspection equipment; orthogonal frequency division multiplexing; robotic lawnmowers; immune system biologicals; Bluetooth applications; defibrillators; ocean thermal energy conversion technologies; oil services technologies; loyalty marketing technologies; catalytic heating; trademarks related to specialty apparel; wireless applications; software for schools; database software; sports drinks; audio cables; solar panels; food processing innovations and personal hygiene products.

Publications – Books

David is the author of three books that have achieved world-wide acclaim, including the only two books that unveil Industry Analysis. These books include Bound for Growth: How to Use Winning Stocks Using Industry Analysis (1997) and Hot Sector Investing: How to Profit from Over 100 Emerging Opportunities (1999). He developed a textbook for his course entitled Valuation of Emerging Technologies.

Publications - Articles

Some of the recent articles written by David Wanetick include:

- Valuation of Patent Applications with Binomial Distribution
- Patent Valuation and Baseball Players
- Costs of Capital - You Can Love More than Just One
- What is the Real Value in Real Options?
- Residual Knowledge Agreements and Neural Prosthetics
- Determining Patent Value Through Claims Analysis
- The Value of Valuing Patents
- How Patent Vulnerability Impacts Valuation
- Strategic Implications of Trade Secrets
- Opening the Kimono on Contract Valuation
- How Sun Tzu Would Outflank Patent Trolls
- The Value of Withheld Indemnifications
- Assessing the Probability of Obtaining a License
- Strategies for Negotiating Licenses
- Winning Negotiations Before They Begin

In addition to dozens of blogs that have published David Wanetick's work, his articles have appeared in:

- Les Nouvelles, published by the Licensing Executive Society
- Intellectual Asset Management
- Patent World
- CEO Magazine
- The CPA Journal
- Licensing Journal
- Willamette Insights
- Valuation Strategies
- Valuation Examiner
- Business Valuation Update
- IP Frontline
- IP Litigator
- Technology Transfer Tactics
- Inventor's Digest

- Private Equity Manager
- Research & Development Magazine
- The Canadian Institute of Chartered Business Valuators

Lecturing

David teaches the following courses through The Business Development Academy:

- Valuation of Emerging Technologies
- Negotiating License Agreements for Maximum Returns
- Financial Modeling and Projections
- Fundamentals of Business Valuation

These courses have been delivered all over the United States (New York City, Princeton, Philadelphia, Boston, Washington DC, Atlanta, Raleigh, Houston, Dallas, Miami, Austin, Chicago, Silicon Valley, San Francisco, Seattle, San Diego), in the United Kingdom, Belgium, Germany, the Netherlands, Singapore, Kuwait, Malaysia, India, Hong Kong and Israel. Attendees from all over the world have participated via webinar.

Representatives from more than 375 Fortune 500 companies have attended his programs. In addition, he has lectured on the above issues before many organizations and corporations such as the Houston Intellectual Property Lawyers Association; The Northeast Technology Council; The New York Society of Security Analysts; The Toronto Society of Security Analysts; The Montreal Society of Security Analysts; The San Francisco Financial Analysts Society; and, The Boeing Company.

From 1997 – 2004, David taught Industry Analysis at The New York Institute of Finance and at The New York Society of Securities Analysts.

Education

David received his undergraduate degree from Bucknell University in December 1988, where he double majored in economics and political science. He pursued a Masters of Science Degree in Taxation from Pace University from 1989 to 1990.

Certifications

David Wanetick earned his standing as an Accredited Valuation Analyst with the National Association of Certified Valuation Analysts. He is a Certified Patent Valuation Analyst and a Certified Emerging Company Analyst.