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Faulty Business Plans Hurt Many Firms From the Start
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It used to be that everyone in Los Angeles was writing a screenplay. Nowadays, it seems everyone is writing business plans for startup companies.

Each week venture capitalists receive dozens of unsolicited business plans. Most are faulty in one way or another, making it highly unlikely that its author will ever obtain the financing needed to create the company so passionately and ineffectively described.

What are these problems that cripple so many business plans of startup companies? Here are six major faults.

Fault No. 1: Emphasis on being "first to market" rather than on size and definition of the market. First to market has become the mantra of entrepreneurs with ideas for new business models, especially in the Internet world. "The first to enter this market will have a long-term competitive advantage," goes the argument, but the real issue is whether the market actually exists at all.

Entrepreneurs should focus less on describing their first-to-market advantage, and put more effort into defining the market, identifying customers and making a convincing argument that they will buy the product or service offered. The collapse of the Internet bubble showed what can happen when money is thrown at "first to market" business plans without first establishing whether markets actually existed.

Fault No. 2: The claim that "We're going to change the way business is done relatively quickly by making or doing things a little better and a little cheaper." The reality is that getting potential buyers to change how they do business usually requires a huge increase in benefits or a significant decrease in price. And it typically takes far longer than was expected.

Consider the dedicated word processor. Introduced about two decades ago, it was touted as the replacement for the typewriter, but at well over $10,000 each it was far too expensive for widespread use by small business and well out of most consumers' reach. It never achieved wide usage outside large businesses.

Then along came personal computers, which could not only do word processing but also perform other valuable functions such as spreadsheet analysis. And they sold it for less than $5,000. PCs quickly vanquished the first dedicated word processors and then typewriters – and most of the companies that made them. Would this have happened if PCs had been priced only 10 or 20 percent less than dedicated word processors? Probably not.

Fault No. 3: Unrealistic projections. This is common even among experienced entrepreneurs. It's not unusual to see business plans promising or implying a return on equity of 50 or even 100 percent for years to come. Even if this profitability is achieved initially, it's almost always unsustainable over time. After all, if a new business model delivers high returns, investors will take note and finance competitive enterprises.

Even if a company has a patented product and doesn't publicly disclose financial information, competitors will still crop up to drive down ROE to a more reasonable 20 percent. For example, Microsoft, which the government claims is essentially a monopoly, generated an ROE of 22.6 percent in 2000. So investors naturally become very skeptical when business plans call for a return on equity year after year that exceeds that of Microsoft.

Fault No. 4: Thinking too small. Often entrepreneurs approach venture capitalists with business plans focused on small markets. "Give us $2 million and we can be a $10 million business in five years," the capital-seekers say. To a venture capitalist, that pitch is very unappealing because it takes virtually as much of a VC's time to evaluate and fund a small opportunity as a large one. Thus, the first thing most VCs want to determine is whether a company can grow very big very quickly. The smallest opportunity most top-tier VCs will consider is one that could reach $500 million in five years.

Fault No. 5: Asking for more money than management's credentials justify. Even if an entrepreneur can make a strong case that a startup company can capture a large share of the market for its products, the amount of capital that can be raised is largely determined by the track record of the management team. A company seeking $20 million will have little trouble getting it if its management team has an outstanding track record.

If management's experience is only average, it may be necessary to raise that $20 million in stages. The first stage investment might be as little as $1 million. Then, if the business plan's short-term goals are met, the second stage investment might be $5 million. If everything continues to go well for the next year or two, it then may be possible to obtain not only the $14 million balance of the $20 million sought at the outset but even more.

Fault No. 6: Overly long plans. Quantity does not mean quality. Some entrepreneurs prepare plans of 50 or even 100 pages, filled with a great deal of meaningless detail, such as the projected cost of stationery. Venture capitalists know that such plans betray an inability to focus on the key elements that will make a business work, and so few if any will read lengthy plans. A good rule of thumb is that a business plan should be no more than 30 manuscript pages, including financial data.

Not every business plan has all of the six faults identified above, but most contain at least one. Hopefully, these cautionary notes will help some Los Angeles entrepreneurs develop business plans that appeal to investors. Those who don't heed this advice might as well go back to writing screenplays.