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ArtsApp.com – Digitizing the Music School Application Process

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Teaching Note

ArtsApp.com – Digitizing the Music School Application Process

"If at first you don't succeed, try, try again. Then quit. There's no point in being a damn fool about it." - W.C. Fields

Case Overview

This case focuses on the evolution of the ArtsApp.com business, launched by a senior undergraduate in an entrepreneurship program. It provides a tangible experience of the student-entrepreneur maturing to full-time entrepreneur, as well as an opportunity to explore some personal feelings, emotions and pressures unique to the student entrepreneur. This case is well-suited as an introductory case in undergraduate entrepreneurship courses that have a focus on opportunity recognition.

The main issues for case discussion include:

1. Crafting Opportunity from Experience
2. The Opportunity Identification Heuristic
3. Obtaining Resources to Pursue the Opportunity
4. Understanding Critical Factors for Success
5. Understanding the difference between Risk and Uncertainty
6. Basics in Modeling the Financial Opportunity

Assignment Questions

The following assignment questions should highlight these issues:

1. From the student entrepreneur perspective, what is your opinion about Dejen's approach to finding an opportunity? What behaviors did he engage in that you can adopt to advance your understanding and progress towards owning a business?

2. Assess the opportunity in terms of Unique Value Proposition and the POCD framework. Is this a good opportunity? Why? Why Not? Be sure to organize and site information from the case as evidence of your position. Is there information you wish you had that is not presented in the case?
3. What are the Critical Factors for Success? Does the team possess the skills and does Dejen control all the Critical Factors for Success? Why is this important?
4. Critique the ArtsApp.com financial model, as presented in the appendices. What is missing and why? How would your sense of the opportunity change if more typical information were accounted for in the pro formas?

Pedagogy and Discussion

This is an undergraduate introductory case. It spans a wide range of issues facing the entrepreneur (more specifically the student entrepreneur), and sets up a number of topics addressed in many introductory or survey entrepreneurship courses.

Furthermore, it provides enough financial information and business model information to guide students through the process of understanding how to measure risk and return in early stage ventures and understand the dimensions of a business model and their effect on the opportunity.

One approach to classroom discussion is to have students form teams at the beginning of class, and spend a few minutes preparing a pitch for ArtsApp. This puts them in the position of being Dejen and having to articulate the business case, and will likely bring out some of the issues that will come up in the POCD breakdown. Have one or two of the teams present their pitch for critique, and then move on to teasing out the case questions on the whiteboard.

1. *What behaviors and attitudes did Dejen possess that you can adopt to help you move forward in your desires for business ownership?*

This case explores a few of the characteristics of the Millennials generation and allows the class to explore those traits and behaviors Dejen exhibits that have lead him to a place of confidence and motivation to succeed.

The Millennial Generation:¹ It may be interesting and useful to highlight characteristics of the Millennial Generation as a process for students in the classroom to understand their strengths better. They will be in a better position to understand Dejen and his strengths as an entrepreneur:

Special: It has been instilled in the generation that they are vital to the nation and to their parents' sense of purpose. They feel that are here to solve world problems that older generations have failed to solve.

Sheltered: Millennials are the focus of the most sweeping youth safety movement in American History.

¹ Howe, N. and Strauss, W. (2003). "Millenials Go To College." www.lifecourse.com.

Confident: They are motivated, goal-oriented and confident in themselves and the future.

Team-Oriented: They want to be seen as part of the group. They dislike selfishness and are oriented toward service learning and volunteerism.

Achieving: Focus is on good grades, hard work, involvement in extracurricular activities, resulting in higher achievement levels.

Pressured: They have been pushed hard to achieve and to take advantage of opportunities. They may take on too much.

Conventional: They are civic-minded and highly value their parents' opinions.

If this framework is applied to Dejen we see some interesting behaviors emerge:

Special: Dejen wants to improve the process of music school applications because he felt he could make a bigger impact on music in this manner.

Confident/Achieving: Dejen arrived at UST already good at something: Jazz Saxophone. Others may become good at something during their time in college or perhaps later in life. Being really good at something is one of the hallmarks of success in the new economy for Millennials,² and the professor may aid each student during this discussion in identifying what they are already good at and what they will become good at doing.

Team-Oriented: Dejen immediately began to associate with student groups, including the Entrepreneurship Society and the Practicing Entrepreneurs group. He was involved in other campus groups and engaged in volunteerism. He also took on additional leadership responsibilities as a dorm deal. All this led to him receiving "Tommy of the Year," a very prestigious designation given to him by the students and faculty at the University of St. Thomas.

At this point the students can be challenged to articulate the things they are doing, or could be doing, to build their reputation and stature within the college community and beyond. In doing so, they will build their own character and leadership experience, make important network connections, and establish their trustworthiness and maturity.

Many sophomore/junior level students will still be questioning their confidence and validity as a potential entrepreneur. This can lead to the following discussion of different paths to business ownership and the concept of risk.

The two general paths to having your own business are 1) Wait and 2) Do It Now. Each have their pro's and con's, but it's useful to highlight those in the context of one's personal risk situation: Risk = Cost of Failure X Chance of Failure.

² *The Talent Society*, David Brooks (2012) http://www.nytimes.com/2012/02/21/opinion/brooks-the-talent-society.html?_r=2

From a student's perspective, the cost of failure can be argued to be the lowest at this point in their career. No spouse, no children and no mortgage. It can also be argued that they are at a relatively high probability of failure. They suffer from a lack of experience, personal and financial resources and little legitimacy, giving rise to a higher probability of failure.³ Yet, it may be argued that the cost of failure, over time, rises much quicker than the chance of failure decreases, resulting in the overall risk to starting a new venture being at its lowest point while a student or early in their post-graduation career.

2. *Is the ArtsApp.com opportunity a good one? Why or why not?*

Having worked through some of the traits that lead to being a successful student entrepreneur and outlining the general risk profile of a student versus seasoned, career focused employee, the discussion can now move to the nature of the opportunity.

A definition of the Unique Value Proposition for ArtsApp.com is a good place to launch a discussion of the opportunity. It is helpful to have students organize their thoughts on UVP around answering a few fundamental questions:

1. What problem is being solved?
2. For whom?
3. Is it the right problem?

The ArtsApp.com UVP appears to solve two problems: The cost problem and the convenience problem, for administrators and adjudicating faculty. Once the students have articulated the UVP, it is worth debating which of the problems and for whom are most compelling.

The Cost Problem

According to the case, ArtsApp can save a music program \$5,248 in labor, but charges them up to \$2000/year for that service, for a net savings of \$3,248.

Aspen Arts Festival saves: $\$3,248/\$21,000 = 15.5\%$ on labor costs, which is significant. Most businesses would like to trim labor costs by 15%. Alternatively, we can look at it on a per applicant basis, the savings amounts to:

Before ArtsApp.com:
 $\$21,000/6,400 \text{ CDs} = \$3.28/\text{CD}$

After ArtsApp.com:
 $\$17,752/6,400 \text{ CDs} = \$2.77/\text{CD}$

³ J. Singh, Tucker D. J. and House R. J. (1986), *Organizational Legitimacy and the Liability of Newness*, Administrative Science Quarterly, 31, pg. 171-193.

A savings of 51 cents per CD. It doesn't sound compelling, but again it is over 15% savings.

The Convenience Problem

The ArtsApp.com service creates a real economic benefit for music programs, but perhaps the benefits of increased convenience are even greater. It is arguable that increasing convenience, and at the same time a larger pool of applicants to choose from, increases the pool of high quality applicants from which to choose. It is a service that makes it easier to recruit better students at a lower cost of recruitment per student.

POCD analysis of Opportunity

The POCD analysis allows students to organize their analysis of an opportunity along dimensions typically considered by sophisticated investors.

People

- Background and experience with music and music schools, especially as applicant;
- Entrepreneurship education;
- Built reputation on campus as a leader and person who gets things done;
- No technical background;
- No sales experience;
- No business management experience;

Opportunity

- 800 institutions with 2.8 million applicants;
- Business model that minimizes risk (flat rate to institutions) and creates recurring revenue (per application fee to students);
- Low total cost of operations
- But, low/no growth market;
- Institutions slow to change;
- Institutions on annual budget cycle;
- Despite UVP, institutions have been slow to adopt. Why? Is UVP not compelling enough? Do they not trust a start-up firm to handle applications?

Context

- No direct competitors;
- Emerging digital music distribution models;
- Growth in broadband/video web distribution models;
- Decline of the music CD as a way of distribution;
- Advances in personal technology products to enhance digital distribution;
- Continuing heavy investments in IT at corporate and government levels;
- Increasing use of Social Media platforms;
- Decreasing cost of data storage (server space is becoming a commodity);

Deal

- Is there enough room in this market to continuing raising money and generating a return to investors after the restart of the web platform?
- Is there an approach to financing that can itself continue to create value for existing and new investors?

3. *What are the Critical Factors for Success?*

Before getting into the financial aspects of the opportunity, it is important to ask students to consider the Critical Factors for Success. These factors usually have an operational aspect to them and lead to a discussion of factors under control of the entrepreneur. Those outside control of the entrepreneur typically translate directly into increased risk for the investor.

Critical Factors for Success:

- Effective Educational/Government Sales;
- Cost effective technology development and deployment;
- Customer Support;

Arguably, Dejen did not have direct experience or control over these CFS, and therefore the risk of the venture was higher. This, in and of itself is not a major deterrent, as investors will understand this and fall on the judgment and character of the entrepreneur to effectively deal with them as the need arises. Obviously, this issue did arise and it was not a small one.

4. *Evaluate the Financial Model and Opportunity.*

First it is useful to tease out the business model and help students understand the difference between the business model and the financial model.

The business model is relatively straight forward. ArtsApp charges institutions an annual flat fee of up to \$2,000. Applicants pay an \$11.00 application fee to ArtsApp. If we assume the average program has 3,500 applicants (2.8 million applicants divided by 800 institutions), the annual revenue per institution for ArtsApp is:

Subscription Fee: \$2,000

Applicant Fees: 3,500 x \$11.00 = \$38,500

Total: \$40,500 revenue a year

Pros and Cons of the model

- Subscription model ties program to ArtsApp.com;
- Recurring revenue leverage built into applicant fee;
- Recurring revenue built into repeat applications each year;
- Highly seasonal revenues;
- Growth dependent on growth in programs not growth in revenue per program;

If ArtsApp.com captures 5% of the market (.05 x 800 programs), that equals 40 schools and programs and approximately \$1.62 million in annual revenue.

So, a student can now see that the assumptions in the business model are baked into the financial model. Let's take a look at the pro formas Dejen developed to raise his initial capital.

Observations:

- The statements don't account for the free overhead, such as the incubator space provided by UST. This makes it difficult to assess the true earning potential of the business.
- The statements don't capture the total equity from Dejen and the investment he was trying to raise.
- It is not clear if he is fairly accounting for labor. Perhaps he is assuming some paid, some internship labor, perhaps some traded for equity in the business. Again, this impacts the earnings potential of the business.

However, we can still help the students get a handle on the profit, risk and return nature of the business. First, start them off by calculating the break even point in total sales in year 3. Help students understand that B/E is a key measure of operational risk that seasoned investors always consider in their investment decision.

Revenue: \$54,676

Variable Costs (COGS): \$13,669

Fixed Costs (Operating + Interest): \$20,280

Contribution Margin = $1 - (VC/Revenue) = .75$

Break Even Revenue = $\$20,280/.75 = \$27,040$

The students should be asked if this is good or bad. One point of comparison is the projected revenue. Break even is 49% of projected revenue and many students will consider this cutting it a little close, without much room for error. Another point of comparison is ArtsApp reaches breakeven with one "average" client, something that seems very much within reach.

A simple way to look at reward is Return on Investment. While there are many other more sophisticated approaches an investor might take, this calculation is relevant and easy to understand for sophomore level students.

Net Income: \$18,252

Equity Investment: \$30,000

Net Profit Margin = $\$18,252/\$54,676 = 34\%$

ROI = $\$18,252/\$30,000 = 63\%$ ROI

This looks extraordinary and in theory would probably compensate the investor for the level of risk he or she is taking in the business. At this point, it is worth noting the risk profile of the investment.

Risk Profile

- Young entrepreneur with no development and sales experience launching a business that depends on technology and sales execution;

Return Profile

- Low organizational cost structure;
- Clear target market and well understood UVP;
- Track record as problem solver and leader;
- Huge revenue and return upside;

How much upside? Perhaps its worth teasing out another scenario in which he hits his revenues on the known actual investment and with a doubling of the cost structure.

Revenue at 5% market share: \$1.62 million

Net Income @ 17% Net Profit Margin = \$275,400

Equity = \$50,000 + \$25,000 family/friends = \$75,000

ROI = $\$275,400 / \$75,000 = 367\%$

Epilogue

Dejen operated ArtsApp for four years, and at the height of the business had over 50 institutional clients. However, competition quickly entered the market and undercut ArtsApp on pricing, and as a result Dejen began to lose clients. After meeting with his professors and advisors, he decided it was not worth trying to grow ArtsApp in a small, niche market where he had to compete on price. He began to call his competitors to get a sense of their interest in acquiring ArtsApp, and a few months later he sold his platform and clients to his largest competitor.