Entrepreneurs need their customers' cash, not government handouts

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10/10/2013

*Many companies that grow to be large and successful never raise any venture capital. So why are we so focused on raising money and putting the investor at the centre of this entrepreneurial phenomenon? **John Mullins** argues that there are a lot of reasons why not to raise capital early and get customer funding instead. Once you have proven your business model and attracted paying customers, you can approach investors from a much stronger position.*

Right now, more than 2 million entrepreneurs are actively engaged in starting a business in the UK. Sadly, many of their ventures will never get off the ground. Of those that do, the majority will fail. Of those who submit business plans to venture capital investors, less than one percent will get the money they seek. Those elite few who do raise money will give away large portions of their company and control. Indeed, many founders who accept VC money are fired within a year after the investment. And government subsidized loans present similar challenges in terms of cumbersome application requirements and challenges of timely repayment.

Despite the challenge of raising money, and the potential downsides of accepting it, whether from private investors or the government, there is a widespread notion that for an entrepreneur to build a high potential business, s/he needs to come up with a great idea, write a business plan, raise some venture capital, and then just wait to get rich. But this vision is basically wrong. Many companies that grow to be large and successful never raise any venture capital. So why are we so focused on raising money and putting the investor at the centre of this entrepreneurial phenomenon? The person who ought to be at the centre of it is the customer, not the investor.

Indeed, there are numerous examples of large, successful companies that have started and grown using their customers' cash: Airbnb, Banana Republic, and Dell, to name just a few. They may have raised investment at some point, but they did it later on, once the business model was proven and generating revenue. Those factors make it much easier to attract funding, and give the entrepreneur a lot more control over the terms of the deal. So, there are a lot of reasons why not to raise capital early and get customer funding instead. "OK, but how?" you ask.

Five Ways to Build a Customer Funded Business

There are five different types of customer funded models – each surprisingly familiar when you think about them carefully – through which creative founders have gotten their customers to fund their start-ups (See Table 1 below).

Table 1: Customer Funded Business Models – Five Types

Type	Category-Defining Examples	Today's Examples
Matchmaker models	Real estate brokers, eBay, Expedia.com	Airbnb, Dog Vacay, Wonga
Pay-in-advance models	Consultants, architects	Via, EasyFairs, Studenterbolaget
Subscription models	The Wall Street Journal, Sky TV	TutorVista, Massage Envy, Yammer
Scarcity-based models	Zara	Vente Privée, Gilt Groupe, Privalia
Service-to-product models	Microsoft	MapmyIndia, Vera Solutions, GoViral

What is most striking about these models is that each of them gives the company what accountants call negative working capital: that is, the company has the customer's cash in hand before having to produce or pay for the good (or service) it has sold. Most of them work for selling either goods or services.

A Customer Funded Model That Has Worked – Airbnb

Airbnb got its start in 2007, when founders Joe Gebbia and Brian Chesky noticed that San Francisco hotels were sold out with a big design conference coming to town. "Why not let visitors to the conference have a more personal experience than they would get in a hotel," thought the duo. So they offered a couple of airbeds on their floor, along with breakfast and local hospitality, to three intrepid conference goers unable to book hotel rooms. Two air mattresses and a thousand dollars later, they were in business. The concept soon expanded – "Why only conferences?" – and took off after the business got noticed during the Democratic National Convention in Denver in 2008.

Matchmaker models rarely need much cash, so getting started is often easy, especially if you bring in someone who can write code and develop a website, as the Airbnb founders soon did, adding techie Nathan Blecharczyk to the team. Fast forwarding to 2013, Airbnb has raised some $120 million in funding from several blue-chip VCs, and now lists over 200,000 properties in 2,600 cities in 192 countries.

Can You Avoid the Opportunity Trap?

Of course, some business ideas are more likely than others to attract customers at all. Which opportunities are most promising can be considered in terms of three crucial elements: markets, industries, and the one or more key people that make up the entrepreneurial team. The seven domains model articulated in *The New Business Road Test: What Entrepreneurs and Executives Should Do Before Launching a Lean Start-Up* brings these elements together to offer a clearer way to answer the crucial question that every aspiring entrepreneur must ask him- or herself every single morning: "Why will or won't my idea work?"

The model is comprised of four *market* and *industry* domains, including both *macro* and *micro* levels, and three additional domains related to the entrepreneurial *team*. These seven domains address the central elements in the assessment of any market opportunity:

- Are the market and industry attractive?
- Does the opportunity offer compelling customer benefits as well as a sustainable advantage over other solutions to the customer's needs?
- Can the team deliver the results they seek and promise to others?

Before You Launch a Customer Funded Lean Start-Up

So, take heart. Road test your entrepreneurial opportunity – from the road, if you like, using the book's accompanying *New Business Road Test* app – *before you even think about* launching a lean, and hopefully customer funded, start-up. If the seven domains road test looks positive, you will have jumpstarted your journey, and you will have gathered a body of evidence with which to guide your launch.

And what if you've found those fatal flaws with your initial idea? You can redirect your precious entrepreneurial talent and energy to another opportunity with greater potential. When you do launch, think about how to get customers to pay earlier and more to help fund the early stages of your business. Once you have proven your business model and attracted paying customers, you can approach investors from a much stronger position. And enjoy the drive along the way!

Note: This article gives the views of the author, and not the position of the British Politics and Policy blog, nor of the London School of Economics. Please read our comments policy before posting.

About the Author

John Mullins *is an associate professor at London Business School. He has also been a senior executive and two-time founder, and took one of his companies public. His newest book,* The New Business Road Test, Fourth Edition*, together with its brand new app of the same name for both Apple and Android, were published this month in response to growing demand for Mullins's insights into entrepreneurship.*