

Market Risk – the biggest threat

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Ventures Capitalists are skilled Investors

As the name implies, venture capital is about providing money for new ventures, and what a risky business this can be!

If you look at the investment portfolio of a typical venture capitalist (VC), you will generally find a range of investments across a variety of industry and scientific sectors with a range of risk profiles. Usually, VC's tend to invest in ventures that are beyond what is referred to as "early stage", where often the science is still being developed or the market initially scoped.

VCs are not government bodies trying to encourage new business and scientific outcomes, but rather they are professional investors skilled in the art of risk assessment and picking the winners from the many opportunities for which their investment funds are sought.

Notwithstanding their skills and experience, VCs, like all investors, also get it wrong on many occasions. It is therefore interesting to look at just one of the issues that underpin investment risk.

In my first book, "THINK NEW" about product innovation, the first sentence reads *"Have you ever been presented with a losing business plan?"*

One of the fundamental problems underlying the preparation of most business plans is that it is the venture champion that most often gets the task of preparing the document. Enthusiasm, positives "vibes", unbounded optimism and a winning feeling are the fuel that powers the writer. Unfortunately, these emotions "fly in the face" of objectivity, and only serve to ensure the writer prepares that "winning business plan".

It is the final page spreadsheet in the business plan that is usually the "clincher". This page quantifies the venture and spell out the financial returns in glowing and simplistic numbers. And what does the writer do in finalising the spreadsheet projections if the profits are not really big enough? Fiddle with the market penetrations, the scope of the market and perhaps the margins. Rest assured, pretty soon the result is that winning business plan.

Writers of such documents are not necessarily dishonest, probably far from it, more than likely they are just passionate. They know this venture will be a winner; they just need to convince the audience of investors so they too can benefit from involvement in this new and exciting opportunity.

Following from the above, it is not surprising that the reason for almost all business failures comes down to markets, you just don't sell as many "widgets" as you forecast in the spreadsheet. Clearly therefore, it is this aspects of any new venture that needs to be most closely scrutinised for that will invariably be the reason for failure.

Marketing, the task of finding the fit between the company capability and the market is what successful business is all about.

Why people purchase things?

What entrepreneurs often fail to understand when scoping a new venture is the simplicity of "value" and the "value proposition".

People purchase things basically because they see value for money. They believe their purchase will allow them to enjoy some benefit equal to at least the value, but preferably exceeding the value, of their investment.

The value proposition, the simple equation that attempts to measure value received compared with the purchase price, is fundamental to understanding markets. In the case of virtually any product whose value is difficult to quantify and communicate to the purchaser, making sales forecasts that underpin an investment decision is little more than educated guess work. Indeed, companies that do succeed with products of esoteric or difficult to quantify value, such as one particular brand of breakfast cereal compared with another, spend vast amounts of money in promotions trying to convince discerning customers that their product offers the best value for money.

When it comes to marketing of any product or service, there are a few fundamentals that need to be clearly understood. Probably the easiest concept to grasp is "in what market category does your product fit"?

Essentially, every product or service can be classified into one or more of the following three:

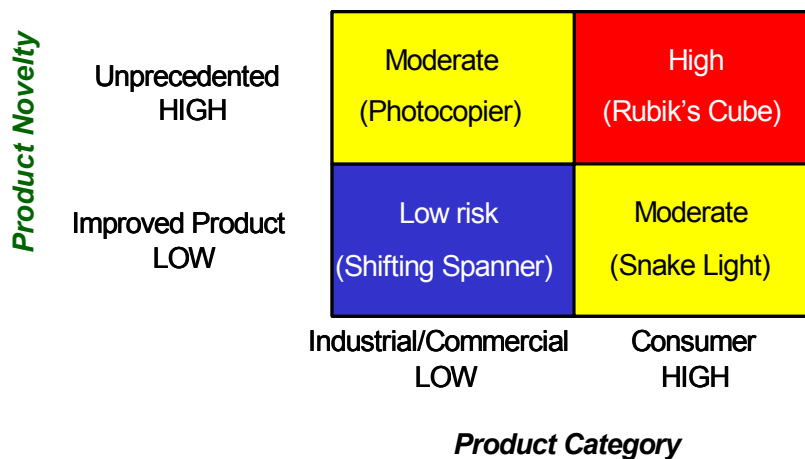
- **Industrial/commercial** – where the purchaser usually makes the buy decision on the value proposition or payback the product will deliver for the investment dollar
- **Consumer**, where the reason for the purchase decision is much more difficult to understand. Home brand products for example are purchased basically on low price, whereas branded products are selected because of the customers' perception of value, and the product value proposition, usually created in the consumers' mind by promotions and advertising.

- **Fashion** products are the ones where brand is essentially everything. Fashion houses and brands invest vast fortunes in building brand awareness and developing the "brand promise"

Once the market category is understood, the next and probably the most important issue to understand is the degree of novelty a product or service brings to the market. Novelty in this context means newness, and although it may be nice to be first with something, being first is often lonely place. History is figuratively littered with the corpses of first to the market failures. Let the pioneers test the market and take all the risks in proving a need and developing awareness. Then follow them with something better.

Often, the place to be is "*fast second*" with something slightly better than the first place getter.

Market Risk Map



It is interesting to present market risk in a diagrammatic form as shown above in what I refer to as a Market Risk Map©.

Note the products and the areas in which they fit.

Being first is risky business

The photocopier and the fax machine were great inventions, but both were so revolutionary that they had a very slow market acceptance. In fact, the photocopier took more than ten years to gain wide market acceptance, so too is the now all pervasive internet. Today, the internet is indispensable, but before it became popular, it was nearly 20 years in gestation.

Even though these products could be called industrial/commercial, in that they are a great assistance to business, their birth was a long and difficult process.

Look now at the compact disc, it is both industrial/commercial as well as consumer. The CD was one of the most rapidly up taken technologies in history. Although the CD was a revolutionary new technology, it was not new to the market as it was simply sold as a better vinyl record, thus it carried little real novelty.

It is the same for the shifting spanner. People can relate to simple tools like spanners, the shifting spanner was simply a much better and more versatile spanner, at a great price. Voila, an instant market success!

Looking at the top right hand quadrant of the diagram, note the presence of the Rubik cube. What a great success that product was, but who would have thought so. Indeed if Mr. Rubik had asked you for upfront investment money, would you have contributed, not likely I suggest. However, if Mr. Shifting Spanner came knocking at your door, I suggest you would have correctly seen this as a great investment opportunity.

Innovation reduces market risk

I believe the message is pretty clear, new products carry a lot of risk, and the best way to mitigate that risk is to improve already well accepted products. This classic Innovation, a term best defined as "**change which adds value**" © La Salle.

Once this definition of innovation is embraced, business building becomes a quite low risk and easily achievable goal.

Remember, most new ventures fail, and failure is most often for market reasons. So in preparing or viewing a business plan pay particular attention to the sales forecasts and understand where the product or service fits on the Market Risk Map and the value it represents from the purchasers perspective.

The next few important questions to ponder are:

- How to communicate your message to the market
- the cost of doing so
- The particular medium for communicating your message
- The risk and reward scenarios.

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