First Avenue Ventures

The Structured Start-Up

WORKBOOK

MODULE 19: IDENTIFYING ASSUMPTIONS AND BIASES

TOPICS COVERED:

How to test one's business plans for blind spots and weaknesses.

LEARN WHAT MATTERS MOST

The Structured Start-Up from First Avenue Ventures
https://learn.firstavenueventures.com

WHAT COULD GO WRONG?

"In his writings, a wise Italian
says that the best is the enemy of the good."
— Voltaire

"Everyone has a plan until you get punched in the face."
— Mike Tyson

"Genius is one percent inspiration and ninety-nine percent perspiration."
— Thomas Edison

"The difference between risk takers and calculated risk takers is the difference between failure and success."
— Leonard C. Green

As we get towards the end of the course, you may realize that in some areas, your business plan is insufficient, or that your business plan is based on assumptions that you think are right but are in fact not. Additionally, although you may be loathe to admit it, there may be weaknesses in your plan and your business that you don't even know about. Our personal perspective and experience shapes our plan -- for better and for worse. Hopefully, the good outweighs the bad and equals success, but we have to continually question ourselves and our plan and continually invite constructive feedback.

The market is, of course, the ultimate arbiter of whether what we are doing is good. Whether you can create a sustainable business is not determined by a business plan or really anything else other than customer use. There are a lot of ways to get to a profitable business or even a sustainable non-profit. Of course, organizations come in all sorts of different shapes and sizes, but the market is the arbiter.

The issue is that in all entrepreneurial endeavors, the noise between the beginning and getting to the market is deceptive, heavy, and confusing. In start-ups, if your view of risk is two-fold – by which I mean it includes both market risk (not enough customers) and execution risk (the team's inability to get to market) -- then there's a tendency to blame execution. Sometimes – but not always – it is the market all along; figuring that out is the challenge.

In hindsight, the answer always seems easy and readily apparent. People pop up with reasons: *if we had only done X, then we would've made it; if Y had just done their job, if we had just a little more capital, etc.* Now what is neglected in this commentary from the variety of people in the cheap seats is that this advice was either not given, not constructively given, or not heard. Entrepreneurs need to listen to advice carefully, hearing both what is said and what is not said, and follow up with questions that address what's said and unsaid.

With this open mindset, we can begin to test our plans for blind spots and weaknesses. Checklists are helpful. Lawyers (when you offer them equity in your company) will draft a document listing potential risk factors for your protection. You'll find a generic form description of risk factors at the end of this module. Usually this is treated as a cursory exercise, but as you go through the form, you can see that these can form the basis of some very real risks for your business.

Hopefully, the last 18 modules have helped you to focus on some of your weaknesses. Where are you weak and what can you do about it? Having both a Plan A and a backup plan (and sometime a backup to a backup plan) can help you move forward.

It is difficult, but I believe that if we consistently question ourselves and our mission, we can find the blindspots all business plans have and move forward.

FORM DESCRIPTION OF RISK FACTORS

GENERAL RISK FACTORS

The following are RISK FACTORS that an investor should consider before investing in the Company.

THE PURCHASE OF THE SECURITIES OFFERED HEREBY INVOLVES A HIGH DEGREE OF RISK AND IS SUITABLE ONLY FOR INVESTORS (1) WHO HAVE A CONTINUING HIGH LEVEL OF ANNUAL INCOME AND A SUBSTANTIAL NET WORTH, (2) WHO CAN AFFORD TO BEAR THOSE RISKS AND A TOTAL LOSS OF THEIR INVESTMENT, AND (3) WHO HAVE NO NEED FOR LIQUIDITY FROM THIS INVESTMENT. EACH PROSPECTIVE INVESTOR SHOULD CONSIDER CAREFULLY THE FOLLOWING FACTORS IN ADDITION TO THOSE DISCUSSED IN THE CONFIDENTIAL INFORMATION MEMORANDUM DATED _______________ (THE "MEMORANDUM").

A. EARLY STAGE (PRIVATE EQUITY) RISK.

_______ a ________ corporation (the "Corporation"), was formed in _______. Below are some risk factors associated with early stage and private equity companies:

<u>Difficulty inherent in start up and managing growth.</u> The Corporation is in its early stage of development and will face the inevitable problems of businesses in the early stage of growth, including, without limitation, the following: (1) lack of a customer base; (2) need for substantial promotional advertising and marketing; (3) difficulty in hiring qualified employees; (4) the inability to convert receivables to cash and (5) a shortage of working capital.

<u>Financial projections may not predict future results.</u> Financial projections included in the Memorandum are based upon a number of estimates and assumptions that are subject to significant business, economic and competitive uncertainties and contingencies, most of which are beyond our control. Our financial projections included in the Memorandum are based in large part on assumptions derived from management's experience rather than actual performance data. No person should rely on the projections of our future results when making an investment decision.The projections are included solely as projections of what financial results might be obtained in the future based on the assumptions and speculations described therein and are not included for the purpose of predicting our future results or revenue or the returns to investors in this Offering

Illiquidity of Investment. An investment in the Corporation will be highly illiquid.Therefore, it should be anticipated that investors will be required to bear the economic risk of their investment for an indefinite period of time. There is not and may not be any public market for the investment, and the equity of the Corporation may not be registered under the 1933 Act or any state securities laws and transfers of the equity will be restricted by law.

Inability to adequately manage growth. The Corporation anticipates that significant expansion will be required to achieve growth in its customer base and market opportunities. Any expansion is expected to place a significant strain on the Corporation's management, operational and financial resources. To manage material growth of its operations and personnel, the Corporation may be required to improve existing transaction-processing, operation and financial systems, procedures and controls, and to expand, train and manage its employee base. There can be no assurance that the Corporation's planned personnel, systems, procedures and controls will be adequate to support the Corporation's future operations; that management will be able to hire, train, retain, motivate and manage required personnel; or that the Corporation's management will be able to successfully identify, manage and exploit existing and potential market opportunities. If the Corporation is unable to manage growth effectively, its business, prospects, financial condition and results of operations will be materially adversely affected.

Intellectual property. The frequency, expense and risks of intellectual property litigation are increasing. Litigation may be necessary to enforce and protect our trade secrets, patents and other intellectual property rights. Similarly, we may be required to defend against claimed infringement. We rely on a combination of contractual rights, trademarks, trade secrets, and copyrights to establish and protect our intellectual property rights in our technology and products. In the future, we may seek to utilize patent protection, but to date have not filed for any patents.However, despite these measures, our intellectual property rights could be challenged, invalidated, circumvented or misappropriated. Competitors may independently develop technologies or products that are substantially equivalent or superior to our products or that inappropriately incorporate our proprietary technology into their products. Competitors may hire our former employees who may misappropriate our proprietary technology. Certain jurisdictions may not provide adequate legal infrastructure for effective protection of our intellectual property rights. Changing legal interpretations of liability for unauthorized use of our technologies or products or lessened sensitivity by corporate, government or institutional users to refraining from intellectual property piracy or other infringements of intellectual property could also harm our business. We rely on several registered and unregistered trademarks to protect our brand. Third parties may use trademarks similar to our trademarks in different fields of use and any potential confusion as to the source of goods or services could have an adverse effect on our financial condition and results of operation.

Inability to protect confidential information. If we are unable to protect the confidentiality of our proprietary information and know-how, the value of our products could be adversely affected. In addition to patented technology, we rely on our unpatented proprietary technology, trade secrets, processes and know-how. We generally seek to protect this information by confidentiality, non-disclosure and assignment of invention agreements with our employees, consultants and third parties. However, these agreements may be inadequate to protect our proprietary information and intellectual property rights. Moreover, those agreements may be breached, and we may not have adequate remedies for any such breach. In addition, our trade secrets may be disclosed to or otherwise become known or be independently developed by competitors. To the extent that our employees, consultants or contractors use intellectual property owned by others in their work for us, disputes may arise as to the rights in related or resulting know-how and inventions. If, for any of the above reasons, our intellectual property is disclosed or misappropriated, it would harm our ability to protect our intellectual property rights and adversely affect our financial condition.

Patents. In light of the recent U.S. Supreme Court opinion, namely Bilski v. Kappos, regarding business methods and process patents, it is impossible to know whether_____may be infringing on valid patents held by others. In its holding, the Supreme Court overruled the current standard for the enforceability of business method patents, but did not set a new standard. Accordingly, obtaining an opinion that the Company is free to operate is particularly difficult and expensive, and the Company has not sought such an opinion.

Possible Additional Capital/ Risk of Dilution. The Corporation could potentially require additional funds, although this is not contemplated currently. The Corporation's inability to obtain such funds will materially impair the company's ability to operate. The Corporation could need to raise additional funds in order to fund the business plan, including the Corporation's anticipated growth, purchase additional devices, supply working capital for central office infrastructure and potentially acquire complementary technologies and services. The Corporation cannot be sure that any revenue generated or capital raised will be sufficient to meet the Corporation's expected expenses in the foreseeable future. If additional financing is not available when required or is not available on acceptable terms, the Corporation may be unable to fund the Corporation's expansion, successfully promote the Corporation's brand name, develop or enhance its products and services, take advantage of business opportunities or respond to competitive pressures, any of which could have a material adverse effect on its business and the value of investments. The actual timing and amount of the Corporation's future capital requirements may differ materially from the Corporation's current estimates. Competitive developments, changes in the regulatory environment and other events may cause us to alter the timing and amount of the Corporation's expenditures. These and other factors also may cause its actual revenues and costs to differ from what the Corporation currently anticipates, which could also affect the timing and amount of its additional funding needs. Sources of additional funding may include the private or public sale of equity or debt securities or commercial bank debt financing. If the Corporation is able to raise additional funds and does so by issuing equity securities, investors may experience significant dilution of their ownership interests. If the Corporation obtains additional financing by issuing debt securities or incurring other indebtedness, the terms of these securities or of the indebtedness could restrict or prevent the Corporation from paying dividends and could contain covenants that restrict its ability to implement its business plan and its flexibility in making business decisions.

Alabama Tax Consequences. Investors who are not otherwise subject to taxation in the State of Alabama may become subject to Alabama income taxation with respect to their shares in the Corporation. Furthermore, the Corporation may be required to file composite Alabama income tax returns and to pay Alabama income taxes for a nonresident investor to the extent that such nonresident investor either: (a) fails to provide an agreement required to be filed with the state department of revenue pursuant to which the nonresident investor will file Alabama income tax returns and timely pay Alabama income taxes on such nonresident investor's proportionate share of the income of the company apportioned to Alabama; or (b) having filed such an agreement, fails to pay the Alabama income taxes due at the required time or times.

Absence of Review by SEC and State Securities Commissions. Since the Offering is a private offering and is not registered under the 1933 Act or under state securities laws, this Offering has not been reviewed by the SEC or the equivalent agency of any state. Review by any such agency might result in additional disclosures or substantially different disclosures from those actually made.

RISK SPECIFIC TO CORPORATION AND ITS INDUSTRY

In addition to the risk associated with an investment in an early stage (private equity) investment, the Corporation has risk associated particular to the Corporation itself and the industry within which it competes:

Key Personnel and Management. The Corporation depends upon a few key managers to generate revenues and for strategic planning. The loss of key management would have a material adverse affect on our business.Future success depends in large part upon the continued services of our key managers. The loss of any manager, and in particular ________, the Corporation's President and Chief Executive Officer or ______, Chief

Technology Officer, would adversely affect our business.Additionally, the initial founders, managers and investors will maintain a controlling interest in the Corporation, and the interest of the investors and the management may not always be aligned.

Employment Agreements. ________ is subject to an employment agreement with their current employer that limits their ability to compete and prohibits the solicitation of their current co-workers. Counsel has reviewed the employment agreement who has advised on compliance with respect to post restrictive covenants. However, the cost of litigating would be substantial (regardless of the outcome) and no assurance can be given that the _________ and the Company would be subject to such a lawsuit.

Heavily capitalized large competitors. The _____ marketplace is highly competitive and is characterized by rapid technological changes. The Corporation may face competition given that many established companies (____,_____, and _____ etc.) have developed _____ focused on helping [CUSTOMERS]. While none of these companies currently provide a holistic solution similar to that of the Corporation, if they did, then the larger competitors have greater resources to develop new products and technologies and market those products, as well as acquire or develop critical components at lower costs, which would provide them with a competitive advantage. They could also exert downward pressure on product pricing to gain market share.

Our ability to compete depends on factors both within and outside of our control, including the price, performance, and acceptance of our current _____solutions and any products we develop in the future. Our competitors could develop new products, with existing or new technology, that could be more competitive in our market than our ____ solution. We cannot assure you that we can compete effectively with any such products.

Failure to anticipate and respond to market trends. The Corporation's success depends in part upon our ability to anticipate rapidly changing technologies and market trends and to adapt services to meet the changing information needs of our clients. The environment of rapid and continuous change presents significant challenges to our ability to exploit the market.

Meeting these challenges requires awareness and responsiveness. Any failure to continue to provide insightful and timely analysis of developments, technologies, and trends in a manner that meets market needs could have an adverse effect on our market position and results of operations.

Reliance on reliable suppliers. The Corporation will not develop or manufacture its own _______. The Corporation will rely exclusively on relationships with suppliers and manufacturers to supply these ___________ to be used on __________. Based on this dependency, the Corporation may encounter supply problems affecting its ability to meet customer demand for services, delay shipments, or increase costs. At present, our ______s are contract-manufactured in China and any disruption in trans-Pacific cargo freight whether due to human or natural causes, as well as trade or foreign currency problems with China, could adversely affect our ability to receive shipments from our supplier.

In the event that a supplier is unable or unwilling to continue to manufacture our product in the necessary volume, the Corporation will have to identify, qualify, and contract with a substitute supplier. Although we believe that there may be potential alternate suppliers available for these critical _______, to date we have not qualified additional vendors beyond those referenced above and cannot assure you we would be able to enter into arrangements with additional vendors on favorable terms, or at all. This may result in unforeseen operating problems.

Dependence on _______ as customers. In order to reach its business plan, the Corporation depends on the execution of exclusive contracts with ______. Each customer has its own procedure for entering into such contracts and each _______ requires different levels of approvals from disparate departments within the ______. Accordingly, the Corporation has a long sales cycle which may not ultimately result in executed contracts. Failure to achieve a sufficient number of executed exclusive contracts will materially impair the ability of the Corporation to achieve its financial goals.

Development/ Scalability. Our ability to manage a substantial amount of traffic on the Corporation's ______ while maintaining superior service is critical to the operations of our business. While the ________ system has been tested in certain environments, no assurance can be made that our ________system will be able to maintain current quality of service as the number of our customers and amount of traffic grow. Our failure to maintain such level of service would significantly reduce customer demand for our services and have a material adverse effect on our business.

We have taken steps to insure the reliability of our __________ and protect them from _______. We have also taken steps to protect the ________.However, in the event an _________ or the entire Corporation's _______ were to suffer from a _______ or a failure, our reputation could be imperiled and would result in a materially adverse condition.

CONFLICTING DYNAMIC

This is directed more at advisors (such as First Avenue Ventures) than at businesses. It's about rendering advice, which is a skill unto itself, and a skill that we do not profess to master. We want to:

- Give feedback only when requested and
- Be open to the fact that something new is possible, but
- Be realistic and up front in our assessments.

When it comes to people, if you have experience with someone on the team, be candid about that person's strengths and weaknesses. If negative, put your comments into context: usually, people simply get into situations that they are not prepared to handle, meaning that they're not necessarily bad people. That can serve as a basis for further discussion.

Resilience and tenacity are great; stubbornness and single-mindedness in thinking are not. The line between the two is thin and blurry. Consistently questioning and delving into the weak areas then making realistic assessments between fatal flaw and correctable flaw, as well as seeking out constructive advice – even if you do not want to hear it -- allows you as an entrepreneur to make good plans, adopt those plans, execute on your idea, and ultimately be proud of what you do regardless of its financial success.

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Module 19

QUESTIONS TO CONSIDER

1. Of the general risks to start-ups (i.e., founder trouble, lack of capital, failure to execute on plan), what risk is most real for your start-up and why?

2. What risks are unique to your business?