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# The business model objective: maximizing cashflow and value

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This paper discusses the fifth component of a business model, economics. Previous papers have described the definition of a business model[1], and its other four primary components: markets[2], products[3], processes[4] and people[5]. "Economics" refers to the central focus of a business model, its financial model.

A business is fundamentally an economic enterprise, and the primary goal of a business from the perspectives of its primary stakeholders (employees, owners and partners) is to maximize its value (so as to maximize each stakeholder's share of that value).

Some readers may argue that businesses also have important non-economic goals. In agile strategy however, we make a clear distinction between a company and a business. A company is a human organizational entity, with vision, values and other non-economic aspects. Normally the primary purpose of a for-profit company is to own and maximize the value of one or more businesses, but it can also have other purposes. By contrast, a business is an economic entity – specifically the value exchange between its stakeholders and its customers. In this sense, a business has a single purpose – to make money for its stakeholders by delivering value to its customers.

A business does so by selling a product or service that customers want and will pay for (because the value of the product or service to the customer is worth more than the payment). It then shares that customer payment amongst all the people (stakeholders) who help provide that product or service to that customer.

These people or stakeholders fall into two main groups – those who actually do the work of providing the product or service (employees and partners) and those who provide capital to the business (owners / investors). Most businesses need capital because of the timing of these payments – normally a business has to share the payment with its employees and partners to provide the product or service before it receives the payment from the customer.

This simple description identifies the five components of a business model. The customer is the *markets* component; the product or service is the *products* component; the providing of the product or service, encompassing all the activities needed to create, market and deliver the product to the customer, is the *processes* component; the employees, partners and investors contributing to and sharing in the value are the *people* component; and the payment and how it is shared amongst stakeholders is the *economics* component.

This simple description also illustrates how a business is a seamlessly integrated economic engine. The customer you choose determines what product or service you can sell and at what price. The processes you choose (how you will make, market and deliver the product or service to the customer) are dependent on the nature of your products and markets, and in turn determine which stakeholders you need. Conversely, the stakeholders you choose can impact which markets you pursue, which products you offer and what processes you implement. Each of these choices, and all of their underlying details, has a material impact on all of the others, and collectively they determine the economics of the business. To maximize the economics of the business, you need the optimal balance of markets, products, processes and people.

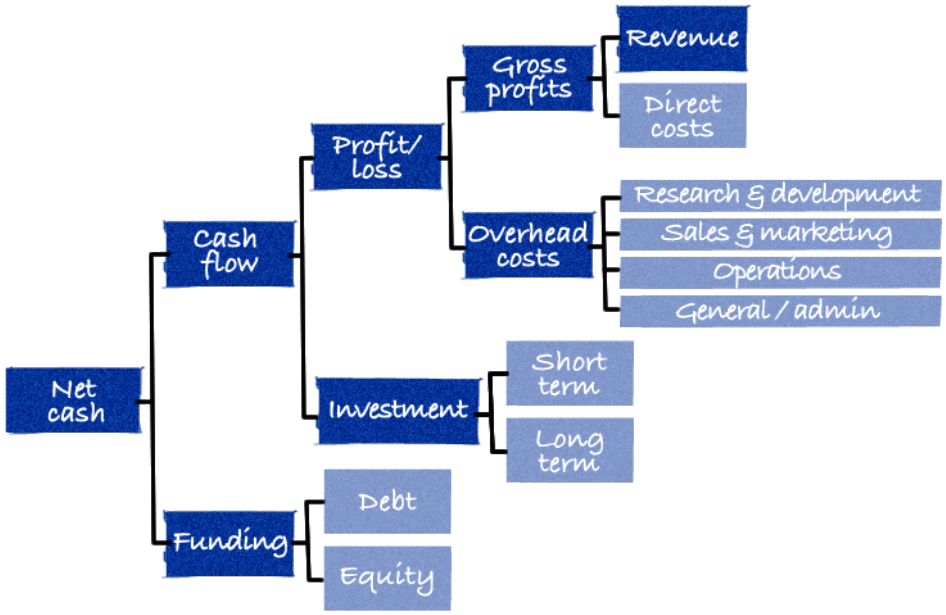
In addition, this simple description illustrates the key elements of the economics component: revenue, costs, profit, investment and funding. The payment from the customer is *revenue* to the business. The share of that payment that it gives to its employee and partner stakeholders are *costs* to the business (where "partners" includes all vendors, channel partners, etc.) and the share of that payment that it gives to its owner stakeholders is its *profit*. The capital it receives is *funding*, and paying that capital out in advance of receiving payment from customers is *investment*.

We now describe three tools that are very useful in designing the economics component of the business model: an integrated cashflow model, a key driver analysis and the cash and valuation curve.

**Integrated cashflow model**

The first tool is an integrated cashflow model that comprises all of the elements of the economics of a business (exhibit 1). What follows is a brief overview from a general management perspective. Interested readers can consult one or more of the myriad texts available for more detail[6].

*Exhibit 1: cashflow model*



*Revenue* is the foundation of the cashflow model for a business[7]. Without revenue, there is no business. Revenue is a function of volume, price and timing – the number of products or services sold, the average price per sale, and the timing of the payments e.g. as a lump sum or in monthly installments. The business model ideal is recurring revenue – i.e. each customer generates repeated revenue for the business.

*Gross profit* is revenue less the direct costs of the product or service. These might include parts and labor for products, and direct labor for services. Managing gross profit is critical, because if revenue does not at least cover direct costs, then every time you sell a product you actually lose money – and as the old joke goes, you can't make up for it on volume!

It is also useful to analyze all direct costs (also known as variable costs). For example, if sales commission is a cost incurred on every sale, this should be included in a total direct cost analysis. This way you can clearly see to what extent your revenue covers your total direct costs. However, for comparison purposes with competitors, and in presenting financial plans or results to investors, traditional gross profit definitions should be used to avoid confusion.

*Overhead costs* are generally fixed, i.e. they do not vary directly with revenue or number of products sold. These can be divided into cost categories reflecting your primary processes (research and development, sales and marketing, etc.).

In exploring your business model's economics, recognize there is typically a risk – return tradeoff between fixed and variable costs. Having low fixed costs and high variable costs is less risky but may be higher cost overall (because there are fewer scale economies). This is the preferred model for early stage businesses where volumes can vary significantly, and may not consistently cover fixed costs. The goal here is to minimize risk and get to profit as quickly as possible.

High fixed costs and low variable costs are more risky but may be more efficient, especially in static, growing markets where scale economies can be very important. This is true for established businesses growing at a predictable rate. Here, the risk is reduced due to the stage of business evolution and the maturity of the market. The emphasis should be on efficiency and cost reduction.

Gross profit less overhead costs result in the business' *profit or loss*. In practice there are different measures of profit (operating profit, EBITDA, net profit, etc.), but these are beyond the purview of this paper. Revenue, direct costs, gross profits, overhead costs and profits are all reflected in the income statement of a business.

In addition to revenue, costs and profits, the cashflow model also needs to include investment and funding (the balance sheet elements of the economic model). *Investment* is basically spending cash in advance of receiving revenue from customers. It comes in two variations. Long term (also known as fixed or capital) investment is incurred to buy or build the necessary foundations for the business such as the initial product development, initial creation of systems, equipment and processes, etc. These are normally one time, relatively large expenditures. Short term (working capital) investment is incurred to produce product inventory and allow customers to buy now and pay later. In our experience, failure to properly understand and manage both types of investment is a common problem for many businesses.

*Cashflow* as the term is commonly used normally refers to profit less investment i.e. the net cash generated or used by the business. The objective is to generate net positive cashflow – i.e. to make sufficient profits to cover both short and long term investment.

Where the cashflow is net negative, it must be *funded*, either through debt or equity. Equity and long term debt is normally used to fund start-up losses and long-term investments. Short-term debt is best used to fund short-term investment – though many entrepreneurs, this writer included, have used short term debt to fund business start-ups!

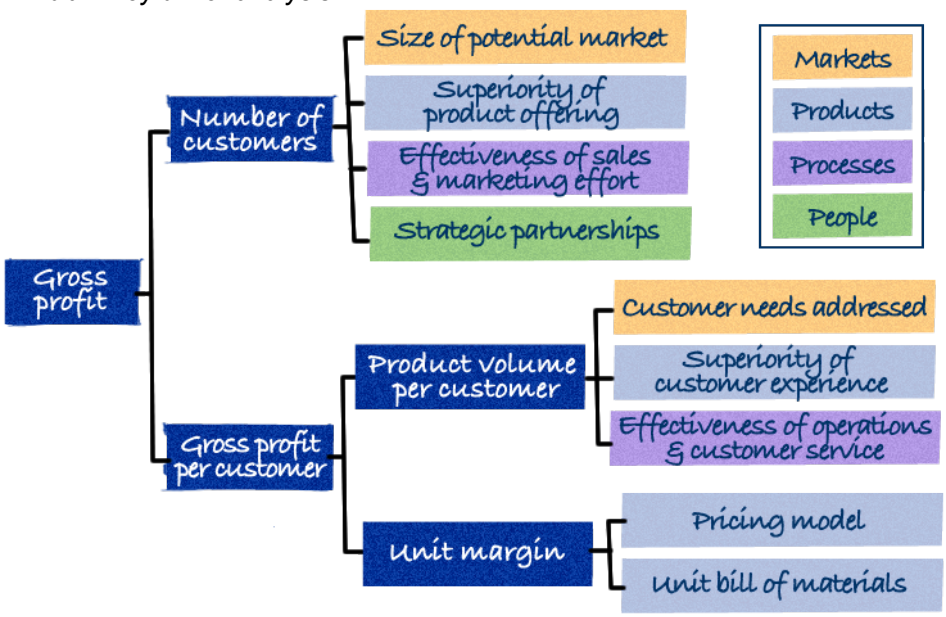
Every businessperson needs a sound understanding of this integrated cashflow model in order to make sensible product, market, process and people decisions.

**Key driver analysis**

The second tool is a key driver analysis. Each of the elements of the cashflow model – revenue, direct costs, gross profit, overhead costs, profit, investment, cashflow and funding - are a result of different business model decisions. Understanding how these business model decisions drive cashflow is critical to business model design and optimization.

The key driver analysis, based on an approach developed by McKinsey & Company, Inc., comprises two steps. The first step is to think first about the key *operating measures* that underlie each element of the cashflow model. In exhibit 2, for example, gross profit in a sample business might be viewed as a function of two key operating measures – number of customers and gross profit per customer. Further, gross profit per customer might be a function of two other operating measures – product volume per customer and unit margin per product.

*Exhibit 2: key driver analysis*



Identifying these operating measures in this way tightly links them to the cashflow model. In this example, the managers of the business know that in order to increase gross profit, they need to increase the number of customers, increase the product volume per customer and / or increase the unit margin per product. These operating measures can be built into real-time reports that provide continuous feedback on business performance.

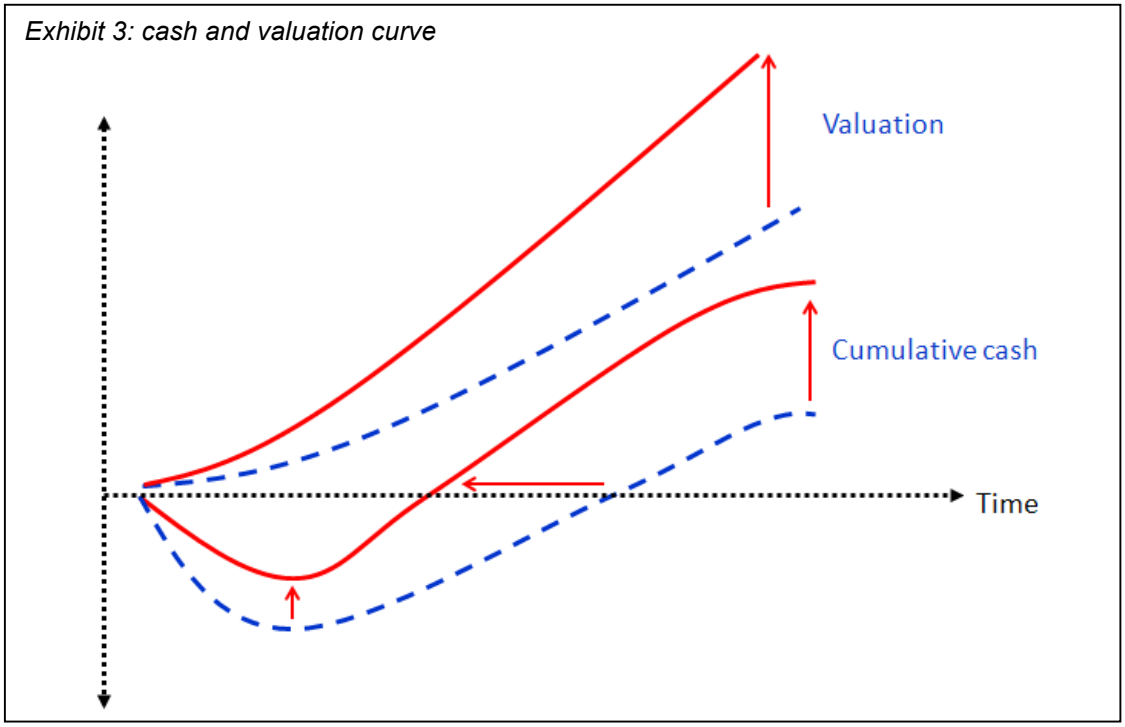
The second step is to identify the key business model elements that drive each of these operating measures. There are typically several of these for each operating measure. For example, number of customers might be a function of the size of the target market (a "markets" decision in our business model framework), to what extent the product offering is superior to competitors (a set of "products" decisions), the effectiveness of the sales and marketing effort (part of the "processes" decisions) and a strategic partnership (a "people" decision).

In this way, you tie the decisions you make in each of the business model components – markets, products, processes and people – directly to operating measures and the cashflow model. This approach thus gives you complete visibility to the integrated economic system at the core of your business model.

**Cash and valuation curve**

The third tool is the cash and valuation curve. When the cumulative cashflow of a business is plotted over its lifetime, it ideally takes on the shape of the well-known S-curve (exhibit 3).

*Exhibit 3: cash and valuation curve*



In the beginning of the business, the cumulative cash curve trends downward, as cash is steadily invested to build products and launch the business. Once revenue begins to come in, the cash curve turns, and begins to trend upwards. When sufficient revenue has been generated, the cash curve gets to breakeven – i.e. at this point, the business has generated sufficient positive cashflow to pay back the total investment. Thereafter, the cumulative cashflow is all surplus – i.e. pure "profit"[8].

The valuation curve more or less follows the cash curve, because valuation is fundamentally a function of cash flow[9]. In the early stage, the valuation is typically relatively low. As the business moves into positive cashflow, the valuation increases to reflect this.

A primary goal in managing the economics of the business is to move from the blue dotted lines in exhibit 3 to the red lines. By minimizing upfront investment, accelerating revenue and increasing profit margins, you get to cashflow breakeven far more quickly and use far less capital in doing so. Thereafter, the goal is to increase the surplus above the breakeven line, to increase the total positive cash generated over the lifetime of the business. Doing so will drive the valuation up to reflect this increased cashflow.

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In summary, this paper has presented an overview of the "economics" component of a business model, It has emphasized the need to see a business as an integrated economic engine, and to understand the economic impact of every business model design decision. Three useful tools have been presented: an integrated cashflow model, a key driver analysis and the cash and valuation curve. Understanding and applying these tools will contribute significantly to business model design and business success.

**References**


1. For an introduction to how the model was developed and how it compares to others, see What is a business model? A new approach.
2. Selecting and understanding markets for technology innovation.
3. Developing a winning product offering.
4. Optimizing your core processes to execute successfully.
5. Evolving your business as a value exchange between stakeholders.
6. See for example Mullins, John and Randy Komisar. *Getting to Plan B: Breaking Through to a Better Business Model*. Boston: Harvard Business Press, 2009.
7. We do not include realizing value from capital appreciation in this definition. So we exclude, for example, investing in a property and then selling it, or investing in a business like Skype which delivered huge capital returns to shareholders but never generated revenue.
8. For a useful discussion of the cash curve, see Andrew, James P, and Harold L Sirkin. *Payback: Reaping the Rewards of Innovation*. Boston: Harvard Business School Press, 2006.
9. Copeland, Tom et al. *Valuation: Measuring and Managing the Value of Companies.* New York: Wiley & Sons Inc., 1990.


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