THE TITANIC EFFECT

Successfully Navigating the Uncertainties that Sink Most Startups

TODD SAXTON

M. KIM SAXTON

MICHAEL CLORAN

NEW YORK

LONDON • NASHVILLE • MELBOURNE • VANCOUVER

GLOSSARY

A/B testing. An experiment between two variants to see which performs better. Also called split testing or bucket testing.

accredited investor. A person who meets the SEC's qualifications for participating in a securities transaction with a company that is not registered with the SEC, such as a ***startup***. The SEC sets these requirements based on characteristics it deems make the investor able to withstand the economic ***risk*** of buying an unregistered security. It currently defines an accredited investor as one who has:

- an earned income that exceeds $200,000 (or $300,000 together with a spouse) in each of the prior two years and reasonably expects the same for the current year, OR;
- a net worth over $1 million, either alone or together with a spouse (excluding the value of the person's primary residence).

See the SEC rules at www.sec.gov/files/ib_accreditedinvestors.pdf

add-on service. An offering available for purchase only in addition to another, often base-level, offering.

Agile software development methodology. An approach to creating applications that is iterative and incremental. It includes adaptive planning, evolutionary development, early delivery, and continual improvement. It stresses being responsive and adaptable to change.

alpha testing. The first level of product testing. It is usually performed by internal users.

angel investor. An ***accredited investor*** who invests both time and money in early-stage ***startups***.

API (application programming interface). Intermediary software that governs how one software application can talk to another. An API allows two different programs to integrate information from one to the other without compromising either program's integrity.

articles of incorporation. Formal legal documents, filed with the Secretary of State, that establish a company's existence. Typical information in the documents includes company name, address, basic purpose, incorporators, legal representatives, and the amount and types of stock that it may issue.

A-round funding. The money a ***startup*** receives for growth funding. This is typically the first round with venture capital investors. See also ***first round or seed capital***.

backlog. A list of work to do, features to develop, or orders to fill.

bases of segmentation. Characteristics of customers that can divide the customers into meaningful groups. The bases include demographics, behavioral characteristics, and psychographics for consumer customer segments.

Bass Diffusion model. An algorithm developed by Frank Bass that describes how a market adopts new products. It includes parameters to describe the innovativeness of the new product and the degree of imitation, both of which affect the speed of adoption.

benchmarks. Standards against which to measure a ***startup***'s progress. Some investors set benchmarks for their own investment. For example, a company must have a benchmark amount of ***recurring revenue*** after two years in the market. See the metrics section of the Strategy Ocean Chapter for how founding teams can also use benchmarks to monitor their progress.

beta testing. The second level of product testing. It is usually performed by customers and checks that the product not only works but also works the way that customers want. Beta testers are often allowed to use the product for free in exchange for their feedback.

bootstrapping. Accomplishing an activity using your own resources. In ***startups***, bootstrapping refers to funding activities and growth from the startup's own revenue or the founders' personal funds instead of securing funds from outside investors. Generally, bootstrapping involves getting as far as possible with as few dollars as possible.

brand book. A set of rules that describe how a brand works, including the meaning behind the brand and how branding elements like a logo or messages should appear. Also called brand standards or brand guidelines.

break through. Stand out enough against competing ads to get target customers' attention.

bridge loan. A short-term bond or investment that provides cash to meet obligations between funding activities. It is short-term, carries a relatively high interest rate, and might be backed by some form of collateral, such as real estate or inventory.

B-round funding. The second round of ***venture capital*** funding. See ***A-round funding*** and ***first round or seed capital***.

burn rate. The speed at which a ***startup*** consumes capital above revenue, usually expressed as a monthly amount. Total capital available divided by burn rate approximates the expected life of the startup (fume date) if it doesn't secure more capital.

Business Model Canvas. A tool related to the ***Lean Startup movement*** that maps out the key components of a ***startup***, such as key partners, value proposition, and cost structure in a one-page format. It is conceptually on the opposite end of the continuum from a fully articulated business plan. See *Business Model Generation* (Osterwalder and Pigneur, 2010) or www.canvanizer.com for more information.

buying group. An organization where typically smaller businesses band together to coordinate their buying from vendors and negotiate better pricing and terms than they could get on their own.

buyout. The purchase of a controlling interest of a company, essentially "buying out" the existing owners. A leveraged buyout happens when the buyer borrows money for the purchase.

cap (capitalization) table. A list (via spreadsheet or table) of a company's securities and owners that includes equity shares, preferred shares and options, and the various prices paid by stakeholders for these securities. The table shows ownership stakes on a fully diluted basis, thereby showing the company's overall capital structure at a glance.

capped note. A type of convertible bond with a ceiling on the total valuation of the company before the note converts into equity. See also ***convertible note***.

cash-flow positive. A term that describes a ***startup*** that generates more cash each month than it spends. Cash receipts include all paid customer purchases, interest, etc. Cash expenditures include operational expenses, investments in product development, and financing costs, among others. Theoretically, when a startup reaches cash-flow positive status, it does not need to raise additional investor dollars, though it might do so for growth.

channel partners. Organizations who sell, distribute, and service products created by another firm.

common stock. A security that represents ownership in a corporation. If the company has a ***liquidity event*** (see ***exit***), common stockholders are repaid after bondholders, preferred stockholders, and other debtholders have been paid in full.

conversion rate. The percentage of people who took an action, typically describing the success of sales and marketing. For example, if 100 people visit a website and ten buy a product, then the conversion rate is 10%.

convertible note. A bond that a ***venture*** takes to secure capital when the value of the company is unknown. This note can be converted into a specified number of common shares in the future. Since it is a debt obligation, it has a specified interest rate and time horizon. The purpose is to allow a new venture to address some uncertainty before setting a valuation but still give investors an incentive to provide financing during the risky stage of the venture. Also called convertible debt.

CRM (customer relationship management). A ***strategy*** or approach that uses data about customer interactions to increase customer engagement and retention.

Crossing the Chasm model. Undertaking the required steps to help new products spread from "early adopters" to a larger market segment, including the "early majority." This term originates from the book, *Crossing the Chasm*, by Geoffrey Moore.

crowdfunding campaign. A fundraising event that asks many individuals to contribute small amounts, typically $10 to $100, usually either as a donation or as a pre-order of a future product. Most crowdfunding is accomplished through an online platform like Kickstarter or Indiegogo. Under the JOBS Act, crowdfunding can also include investing for equity by non-accredited investors.

debt financing. Borrowing money to use as working capital by promising to repay principal and interest on the debt. This is, in essence, taking a loan to fund operations.

down round. An event in private financing where investors purchase stock or convertible bonds from a company at a lower valuation than the company had in the preceding round. Down rounds are bad for founders and earlier investors whose previously purchased equity goes down in value.

due diligence. An analysis a potential investor makes of all the facts of an investment opportunity, the company's potential, and the founders' backgrounds before committing to investing. Can also include the analysis a founder does before considering an investor as well.

early-stage investor. People who support early-stage ***ventures*** with time or money.

EBITDA (earnings before interest, taxes, depreciation, and amortization). A measure of profitability. It provides an easy comparison between companies because it does not include effects from financing and accounting decisions.

equity. An ownership stake in a company.

exit. A way for early investors to secure a return on their investment. The exit brings new money into the ***venture*** and lets early investors "exit." Commons exit options are an ***IPO*** or ***buyout*** by another company.

first-round or seed capital. First official financing event for a ***startup*** from ***venture*** capitalists, usually to fund product development, early market research, growth, and/or building a management team. There can be several rounds of seed funding and they are usually labeled alphabetically as an ***A-round***, ***B-round***, and perhaps C-round.

four-bit hustler. Like a ***two-bit hustler***, but more expensive. Often costs twice as much, but not always worth it.

frame of reference. The category to which customers perceive a product offering belonging. A frame of reference for a new product offering gives customers a shortcut to understanding what the product is all about.

freemium model. A pricing approach where a basic product is given away free with the intention that most users will upgrade in order to access premium features, services, or virtual goods.

friends and family money. The most common form of ***startup*** funding, in which the founders' personal networks invest. It can take the form of a gift, loan, or equity investment. The SEC does not formally regulate this type of funding. This is a very risky stage of investment.

fully diluted shares. The total number of common shares of stock in a company that would be outstanding if all possible sources of conversion, such as convertible bonds and stock options, were exercised.

fund of funds. An investment device that invests in other types of funds. This investment portfolio contains different underlying assets instead of investing directly in bonds, stocks, and other types of securities, including startups. Also called multi-manager investment.

gazelle. An extremely fast-growing company that maintains consistent expansion of both total employees and revenue over an extended period, often five years or more. There is no single definition of what constitutes an "exceptional" growth rate, but 20% or more annually is a commonly used metric.

groupthink. A phenomenon where members begin to see a shared view of the world that may or may not resemble reality.

hidden debts. The unanticipated consequences of navigating ***uncertainty***.

high-growth. Quickly increasing in size, usually indicated by sales revenue. A specific description of a high-growth rate may vary over time and by industry, but is typically is several multiples over GDP growth.

Hype Curve model. A graphical representation of the stages of growth for technology products, branded by Gartner. A market described by a Hype Curve typically adjusts to a lower total level of value after a short period of irrational exuberance and high demand.

IPO (initial public offering). The first time shares of stock in a company are available on a securities exchange or to the general public. An ***IPO*** is a mechanism for raising capital. After an IPO, a private company becomes a public company listed on a stock exchange as regulated by the SEC. This provides an ***exit*** or ***liquidity event*** for early investors in a startup.

inbound marketing or advertising. Attracting customers who are already interested in your product category by providing "relevant and helpful" content aimed at the stages of the customers' buying process. It typically is predominantly online content via digital marketing and tied to online search by potential customers. This term originated from the company HubSpot.

lagging indicators. Metrics that focus on outputs and summarize what has already happened. Unemployment, for example, is a lagging indicator because it tells how many people were unemployment in the past time period.

land-and-expand strategy. The process of engaging in a small deal with a new customer intending to secure a bigger deal over time. B2B companies typically use land-and-expand strategies.

launch and early growth. The stage of a ***startup*** that comes after developing an MVP. A product or service is available in the market and revenue is being generated.

lead investor. A ***venture capital*** firm, ***angel investor***, or individual investor that is the first to put up money and organize a specific round of funding for a company. The lead investor usually invests the most capital in that round and sets the terms, including valuation.

Lean Startup movement. An approach to creating new businesses, captured in works from Eric Ries, Steve Blank, and others, that advocates that new ***ventures*** should launch with rapid development and feedback from the market rather than extended planning periods. Through testing and ***pivoting*** based on market feedback, founders will better understand their market and potential. See *The Lean Startup* by Eric Ries (2011) and *The Startup Owner's Manual* by Blank and Dorf (2012). This movement is powerful in providing rapid feedback and experimentation, but also creates significant ***hidden debt***.

liquidation. The voluntary process of terminating a company's operations and selling its assets.

liquidity event. A situation that allows early investors to cash out some or all of their ownership in a ***startup***. This may also be an ***exit***.

load testing. A quality check that simulates user demands on a software, application, or website to show its performance under different conditions, particularly as volume of users grows.

mass marketing. Targeting an entire market at once.

mezzanine debt. A hybrid form of financing that incorporates equity-based options with a lower-priority with borrowed money with an associated interest rate. The equity component is usually lower priority than earlier stage investors' equity, while the debt component is usually higher priority than existing owners' debt, in the event of bankruptcy.

minimum viable product (MVP). A new offering that has enough features to satisfy the first paying customers, but not enough to consider it a fully functional, scalable product.

must-have feature. A requirement that absolutely needs to be included in order for a product to be viable.

nice-to-have feature. A product requirement that is important but optional if resources are constrained.

niche. A subset of the market that has specific and focused needs. Usually it is a small segment, or even a part of a segment, in the market. Rhymes with "itch," unless you speak French, in which case you will probably say "neesh."

one-to-one marketing. When a company promises to deliver exactly what each individual customer wants. It is an extreme form of personalization that includes the product itself, its price, and how it is promoted.

outbound marketing or advertising. Promotion initiated by a company trying to interest potential customers in its products. Most traditional advertising (e.g. radio, TV, and print ads) are considered outbound marketing. It can also include direct mail, email (other than opt-in email), tradeshows, cold calling sales, etc.

PEP. The combination of passion, experience, and persistence, which are key characteristics of successful founders.

pitch or pitch deck. A tool ***startups*** use to talk to investors about their business opportunities. It is usually a presentation delivered face-to-face and includes information on market potential, the problem being solved, the solution being offered,

the experience of the management team, and other details intended to show the startup is both scalable and investable.

pivot. Change direction in terms of product, business model, or target segment. A popular component of the ***Lean Startup movement***.

points of differentiation. The attributes that make a product offering unique and are the product's competitive advantage.

points of parity. The attributes or characteristics common to all products in a specific frame of reference or category. They are mandatory for a product to be a legitimate member of a category. Because they are common to all category members, they typically do not differentiate a product. See also ***frame of reference*** and ***points of differentiation***.

positioning. The value proposition a product offers to potential customers over its competitors.

post-money valuation. A company's agreed-upon worth after a capital infusion. For example, a ***venture*** raises $500,000 with a $2 million ***pre-money valuation***. The post-money valuation is $2.5 million. As a result, new investors in this round own 20% of the company, or $500,000 of the $2.5 million post-money valuation.

preferred stock. An ownership share that carries a fixed dividend or return that is to be paid out before dividends carried by ***common stock***.

pre-money valuation. The agreed-upon worth of a company before it receives an infusion of capital or before it goes public.

pre-revenue. The first stage of a ***startup*** where an idea is being validated and early product versions are in development. Because a product does not yet exist to sell, the startup has no revenue.

private equity. Securities of unlisted companies. The SEC does not regulate these equities to the same extent as stock offerings to the general public.

product/market fit. The quality of a new offering satisfying a strong need among the people who would buy it. It incorporates both the extent to which there strong demand for a new solution (market fit) and the ability of the new offering to be that solution (product fit).

promotions. Any marketing communication used to attract, inform, and persuade potential customers about a product's value proposition.

proof of concept. A demonstration that a new product idea can feasibly be developed and/or that there is a market for that product. It is the first test of a ***startup*** idea. It does not assess cost effectiveness, only the feasibility of the idea.

recurring revenue. The portion of a company's revenue that is expected to repeat in the next time frame, usually month or year. It comes from repeat buying, often occurring under contract.

reverse-vesting equity. A type of stock given to an employee that is subject to repurchase by the company for an at-cost purchase price, with the repurchase right lapsing over the ***vesting*** period. The idea behind reverse vesting is to give an incentive upfront but also protect the company with the option to repurchase these shares if the employee leaves the company.

risk. Possibility of a loss.

SaaS (software as a service) business. A company that delivers its product by allowing users to log in to the application, as opposed to users installing the application on their own computers or servers.

sales funnel. The process of converting potential customers into actual customers. The steps in the funnel can vary quite a bit depending on industry, brand, and target segment.

scalable venture. A company that has traction in its market and can grow rapidly and profitably. Scalability requires a replicable model that allows revenues to grow significantly without equally increasing costs. This is one of the more advanced stages of ***startups*** described in this book.

second-stage capital. Funds a company raises after it has already begun commercial manufacturing but before its initial public offering.

segment profile or persona. A description of the characteristics of a market segment and/or a semi-fictional representation of the ideal customer based on market research and real data about the segment. The profile often includes a picture as well as a description.

segmented marketing. The process of dividing a market into homogeneous groups and figuring out how to communicate with each group differently.

share of market. The portion of a market that one company or product holds, typically measured as a percentage of revenue or units sold.

sprint. A focused period of time in software development to complete specific work and make it available for review. It is one component of an ***Agile software development methodology***.

startup. A new business at its earliest stage, maybe nothing more than an idea on paper. This term covers businesses from pre-revenue ideation to early growth and scaling.

strategy. A plan that links today's choices and actions to tomorrow's destination under conditions of ***uncertainty***.

technical debt. Limits on a company's future scalability or growth potential caused by the early choices ***startups*** make about software and technology development.

technology stack. The suite of computer platforms combined to form a complete software solution. A technology stack usually minimally consists of a database to store records, a server-side programming language to write and read records and perform business logic, and client-side libraries and tools to build the front-ends that users interact with. Also called the stack.

term sheet. A nonbinding agreement that identifies the specific aspects and conditions of an investment. Once a term sheet is agreed to, a legal document will be drawn up. May also be called a memorandum of understanding.

tradeoff. A compromise that tries to balance between two desirable but incompatible choices.

two-bit hustler. A swindler or slick salesperson who asks for only two bits. Whether the price is fair depends on what the bits are.

uncapped note. A convertible bond that offers investors no guarantee of how much equity their money purchases or the valuation at which it converts. Contrast ***capped note***.

uncertainty. A situation where the nature of the situation is unknown, the outcomes of the situation are unknown, and the probabilities of those outcomes are unknown.

unicorn. A company, usually a ***startup***, with a stock market valuation or estimated valuation of more than $1 billion.

user experience (UX). All aspects of an end user's interactions with a product, including both functional and emotional aspects.

value-added reseller (VAR). A company that adds features and/or services to an existing product to customize it or make it turnkey.

value-based pricing. An approach to setting price based on customers' perceived economic value of the product rather than the cost to make the product.

venture. A risky ***startup*** that has the intent of being financially profitable.

venture capital. Money that investors provide to ***startups*** and small businesses that they believe have long-term growth potential. Startups often receive ***venture*** capital after funds from ***friends and family***, ***angel investors***, and as part of seed

rounds. Startups receive venture capital during A rounds (typically $2 million to $5 million) or B rounds ($5 million to $10 million or more) of funding.

vesting. Accruing rights of ownership in a ***startup*** over time. Vesting also describes how retirement benefits accrue to an employee based on years of service to a company.

vesting schedule. A timetable detailing the when and the extent to which ownership rights accrue to a recipient. Once the ownership has accrued, the recipient may exercise these ownership rights or sell them, if there is a market for them.

vulture capitalist. An investor that buys distressed firms at a deep discount in the hopes of turning them around and selling them off again. Generally, vulture capitalists take advantage of early-stage companies during times of distress.