

JOHN MULLINS, PHD

COAUTHOR OF  
*GETTING TO PLAN B*



THE

CUSTOMER-

FUNDED

BUSINESS

WILEY

# Praise for *The Customer-Funded Business*

“This is THE cornerstone idea for entrepreneurs—to shun all other avenues first and pursue customers to fund their venture. This provides a critical forcing function business leaders need, in order to guarantee they are creating something truly valuable. After learning this lesson the hard way (raising angel funds and failing), my two latest ventures have followed Mullins’ sage advice and flourished.”

—**Verne Harnish**,  
CEO Gazelles;

Author of *Scaling Up* and *Mastering the Rockefeller Habits*

“The customer is not just king, he can be your VC too! John Mullins’ brilliance has inspired my own success for many years and his ideas can drive yours as well.”

—**Bernard Auyang**

Entrepreneur and investor;

International Chairman 2014–15, Young Presidents’ Organization

“Mullins has connected the dots. His clarity of insight blazes through in the five crisp models of the customer-funded business. He sharpens our understanding of how to use the power of market innovations and customer traction to fund emerging businesses. A great set of tools for the new and experienced entrepreneur.”

—**Jerry Engel**

General Partner, Monitor Venture Partners;

Adjunct Professor Emeritus,

Haas School of Business, University of California Berkeley

“John Mullins’ sage advice for entrepreneurs and the investors who back them is just as important for established companies that are trying to unlock innovation and growth. Customer funding is a powerful approach that too many businesses have simply forgotten, or never understood. If you don’t read this book, you’ll lose out to competitors who do.”

—**Mike Harris**

Founding CEO of First Direct and Egg Banking;  
Author of *Find Your Lightbulb*

“Hits the nail on the head. Customer funding isn’t just another source of capital for starting or growing your business. It is—by far—the most intriguing source available. Mullins shows why, and he shows five ways to obtain it, too.”

—**Tom Byers**

Professor and Director, Stanford Technology Ventures Program,  
Stanford University;  
Coauthor, *Technology Ventures*

“A timely reminder not to see your customers only as a source of credibility when you are starting out but as a valuable source of funding—particularly in the early days. Packed with good anecdotes and inspirational tales of entrepreneurial success (and failure), John Mullins nails it again!”

—**Richard Gourlay**

Managing Director, Sussex Place Ventures

“Happiness is a positive cash flow. I remind my students that venture capitalists (and most angels) don’t typically fund new businesses, they fund businesses that are poised to grow rapidly. The five models that John highlights can help entrepreneurs launch and validate their businesses when other sources of capital are scarce and expensive.”

—**Andrew Zacharakis**

The John H. Muller, Jr. Chair in Entrepreneurship, Babson College

“There are many books aimed at helping you develop the perfect pitch to ensure you get investment. But entrepreneurs start businesses, not investment vehicles. This book is a grand journey through many ways that we can build these businesses using other people’s money or shifting our business model. And importantly—keeping the valuable equity to ourselves. Do not raise equity investment until you have read this book and considered every other option.”

—**Dale Murray**

Cofounder Omega Logic, British Angel Investor of the Year 2011

“Worth the price of the book for Chapter 8 alone. Most startups will never have a chance to secure an institutional investment. Some may never need one. John Mullins shows entrepreneurs another path employing proven *Customer-Funded Business* alternatives. Even if you plan on eventually scaling with venture capital, customer funding can be a smart path to experiment and prove your business in advance.”

—**Randy Komisar**

Partner, Kleiner Perkins Caufield & Byers;  
Lecturer, Stanford University;  
Author of *The Monk and the Riddle*

“Very accessible, thorough, and will no doubt be useful to aspiring (or struggling) entrepreneurs. The models are a great analytical tool which the case studies bring to life.”

—**Amar Bhidé**

Schmidheiny Professor, The Fletcher School, Tufts University;  
Author of *The Venturesome Economy* and *A Call for Judgment*

“With *The Customer-Funded Business*, John once again provides us with a fantastic book. If someone is looking for inspiration on how to keep their cash requirements to a minimum and de-risk their investment—this is the first book they should pick up and read.”

—**James King**

Founder and Chairman, Find Invest Grow (FIG)

“Truly engaging. ‘Ring the cash register and sit on the float—and avoid running out of money and going out of business.’ John Mullins convincingly guides entrepreneurs to dump their PowerPoint slides and look to their paying customers as their ‘first ports of call.’ Early stage investors might want to think in similar fashion!”

—**M.S. Rao**

Professor, S P Jain Institute of Management and Research

“Essential reading for any budding entrepreneur—a revolutionary approach to funding a new venture. A fresh perspective on funding and scaling ambitions.”

—**Jim Hall**

Executive Director, Entrepreneurship Centre,  
Saïd Business School, University of Oxford

“Professor Mullins breaks down the myth that the key to a successful business is to raise venture capital first. His prescriptions for finding the right customers and getting them to fund your business are a great step-by-step guide to raising venture capital—build the business first and the investments will follow!”

—**Bill Earner**

Partner, Connect Ventures

“Practical and pithy, and a must read for an entrepreneur, full of pragmatic insights relevant to any entrepreneur or business executive.”

—**Sunita Singh**

Cofounder and Senior Director, National Entrepreneurship Network, India

“A truly fascinating book, long overdue. John Mullins has brought out a completely new paradigm in financing businesses. A lot of business failure will be avoided if entrepreneurs really understand the message and practice it.”

—**Kavil Ramachandran**

Thomas Schmidheiny Professor of Family Business  
and Wealth Management, Indian School of Business

“John Mullins has done it for the third time. After *The New Business Road Test* and *Getting to Plan B*, he has produced yet another book for entrepreneurs, investors and educators that is based on rigorous research and at the same time engaging and practical. He shows how entrepreneurs can postpone raising costly venture funding by obtaining funding from customers in the early stages of their businesses.”

—**Rama Velamuri**

Professor of Entrepreneurship,  
China Europe International Business School, Shanghai

“A timely and healthy antidote to the almost universal focus on financing issues in starting new ventures. Mullins argues very convincingly that for most non-tech start-ups, seeking external financing not only is extremely time consuming and only rarely works, but often is counterproductive to developing sustainable businesses serving real customers’ needs. Mullins builds on his evidence-based approach to entrepreneurship successfully demonstrated in his previous best-sellers *The New Business Road Test* and *Getting to Plan B* and provides would-be entrepreneurs with well-thought-through tool kits and real-life case stories.”

—**Søren P. Hovgaard**

Head of Entrepreneurial Development Unit;  
External Associate Professor, Department of Economics,  
University of Copenhagen

“A paradigm-shift in the way we think about startup funding. While ‘lean startup,’ ‘bootstrapping,’ and other methodologies have had their day in the startup spotlight, reading this book makes me realize that the next decade belongs to customer-funded businesses. And this book shows the way. Starting up, as well as angel investing, has more madness than method. But the five customer-funded models, as well as the ‘John’s Business Angel Checklists’ at the end of each chapter, distill the process down to its essentials.”

—**Ajeet Khurana**

Top-15 Angel Investor, India, 2013

“*The Customer-Funded Business* gets it. Great practical advice for those seeking to crowdfund their ventures. I recommend John’s book to those wanting a grounding in customer-funded business that is also deeply entrepreneurial in spirit. I can’t wait to put this book into action!”

—**Norris Krueger**

Entrepreneurship Northwest;  
Fellow, Max Planck Institute

“Spot on for the entrepreneur as well as the angel investor . . . and even the business professor. Mullins’ wisdom, experience and knowledge of entrepreneurs come through on every page. Particularly insightful to me were the ‘John’s Business Angel Checklists’ at the end of Chapters 2–7. This book should be one that every entrepreneur takes time to read so that they build their business on solid and sustainable ground.”

—**Keith Williams**

Senior Vice President Member Experience;  
Entrepreneurs’ Organization (EO)

“John and I came to very similar insights from over a decade of very different kinds of research into what successful entrepreneurs have learned to do well. This book captures beautifully what an expert entrepreneur I studied told me, ‘Treat your first customers as your partners—they are your earliest investors and your best salespeople.’ The compelling stories in this book invite you and inspire you to learn how to do that.”

—**Saras Sarasvathy**

Isidore Horween Research Associate Professor,  
The Darden School, University of Virginia

“Two of the most critical tasks that you as a startup CEO/Founder have to do are hire the right people and keep your company appropriately financed. While venture finance can accelerate the growth of businesses where appropriate, many times a company can benefit from other, more independent forms of funding their growth, particularly in the very early stages. Applying the concepts and tools in this book will likely make your company that much more attractive to an investor, for the investment capital they give you will be used to accelerate growth, rather than just provide financial subsistence.”

—**Carlos Eduardo Espinal**  
Partner, Seedcamp

“A very timely book. Investors are thin on the ground and entrepreneurs have to turn to alternative and even better sources of investment. Entrepreneurs are asked to prove the merits of their ventures and what better way than through customers. John’s gift for writing makes this an easy read and reminds us that ‘cash is king.’”

—**Dr Shai Vyakarnam**  
Director Centre for Entrepreneurial Learning,  
University of Cambridge, Judge Business School

“Whether you are starting up a business in a garage or doing as I did, building one overseas on behalf of a large North American firm, this book is a relevant and compelling read. You are left in no doubt that Cash is clearly still King! John gives you the tools as well as his practical ‘business angel checklists’ coupled with captivating anecdotes to challenge and ultimately help you choose the right funding model for your business.”

—**Peter Moores**  
CEO and Country Manager UK, Raymond James

“Another great book that gets to the heart of building companies. I wish more entrepreneurs understood the significance and freedom that cash generation can bring to young, fledging businesses. It puts an entrepreneur in the driver’s seat. As a venture capitalist, I dream of entrepreneurs that are able to independently validate their product or service with the market, lay down early traction and are constrained only by capital to take their companies to the next level. John’s book provides a comprehensive framework for thinking about how to generate cash and become self-sufficient as an entrepreneur.”

—**Hussein Kanji**  
Founding Partner, Hoxton Ventures

“Throughout my 30 years in business, finding quality books which get to the heart of key issues for both entrepreneurs and investors has been a rarity. *The Customer-Funded Business* does exactly this, providing excellent, straightforward advice along with real life examples. John has been there and done it in the business world. His knowledge and experience are clear to see.”

—**James Caan**

Author of *Start Your Business in Seven Days* and *The Real Deal*

“John provides a vital sanity check for inexperienced founders. Time chasing investors is often better spent creating (and realising) customer value.”

—**Dave Chapman**

Vice-Dean for Enterprise, University College London

“John Mullins’ expertise is giving us forehead-slappingly new insights into taken-for-granted ideas. In this age of Kickstarter, we all *think* we know all about customer funding, but in this book John shows us Kickstarter is only one of five ways to get customers to fund our businesses. With great stories and great style, John takes what we all know and makes it fit together in new and powerful ways.”

—**Jerome Katz**

Coleman Professor of Entrepreneurship, Saint Louis University

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## Why This Book?

**B**ecoming—and being!—an entrepreneur is difficult. Raising capital to fund one’s entrepreneurial journey is *even more* difficult. Each year—in the good years—only about 1,500 U.S. startups get funded by venture capitalists, alongside another 50,000 or so by angel investors, a paltry number against the 5 million ventures that seek startup funding.<sup>1</sup> According to research from Statista, the numbers these days are worse: only 843 seed-stage deals were done by U.S. venture capital firms in 2013, though that figure is the best in years, more than double the number in 2010.<sup>2</sup> Difficult, indeed!

The numbers elsewhere, including in the UK, where I spend most of my time, are even more daunting. In Europe and Asia, they’re tougher still. I know firsthand how difficult it is, because I’ve been in startup and capital-raising mode multiple times during the first half of my career. In the second half, as a professor at one of the world’s leading business schools, and as a board member and investor, I’ve helped hundreds of individuals surmount—or circumvent!—the fundraising and other challenges to become thriving entrepreneurs. Some, you may be surprised to hear, did it inside large companies. Others, the more typical, got their start in their kitchens or garages, or over a couple of beers at the local pub.

The vast majority of them, however, *didn’t* follow the prototypical path that the conventional wisdom holds as gospel today:

- *Step 1:* Come up with an idea for a new venture.
- *Step 2:* Write a business plan.
- *Step 3:* Raise some venture capital.
- *Step 4:* Get rich!

In fact, most of the companies whose names populate the lists of the world's fastest-growing companies—the *Inc. 5000* in the USA, the *Fast Track 100* in the UK, and similar lists everywhere—didn't follow the conventional script, either.

## Do You Really Need Venture Capital?

What did they do? The vast majority of them *never* took a pound or dollar or rupee of venture capital, and they didn't mortgage or pledge their houses, either. Instead, they managed to find ways to get their businesses up and running, and then growing, *without* pandering to VCs or groveling to their company's CFO. By solving pressing customer problems, or by developing delightful customer experiences that transformed the previously mundane—think Peet's or the UK's Coffee Republic in coffee bars or Banana Republic in casual apparel—most of these entrepreneurs built vibrant, growing businesses *without* raising troves of venture capital. “So where did their funding come from?” you ask. The lion's share of them got most of their money—initially, at least, and sometimes for the entire journey—from a much more hospitable and agreeable source: their customers.

**“they didn't mortgage or pledge their houses, either.”**

pledge their houses, either. Instead, they managed to find ways to get their businesses up and running, and then growing, *without* pandering to VCs or

## The Problem: Limelight Stolen

“Why, then,” you might ask, “have the business plan and the raising of venture capital become seen as the centerpiece of entrepreneurial endeavor?” Two reasons, in my view.

First, the venture capital community—VCs, business angels, incubators, and much of the rest of today's entrepreneurial ecosystem—has stolen the entrepreneurial finance limelight over the past two generations or so, first in California and Boston, and more recently practically everywhere else. They've done so

for good reasons: the sometimes astonishing returns they've delivered to themselves and their investors, and the astonishingly large and valuable companies that this ecosystem has created. The valuations of companies like Apple, Amazon, and Twitter do make good headlines! If all the companies backed by the venture capital industry were thought of as a country, it would stand as one of the world's largest economies today.

**“The valuations of companies like Apple, Amazon, and Twitter do make good headlines!”**

There's nothing inherently wrong with venture capital. I've both raised it and provided it myself. But as we'll see in Chapter 1, VC has some drawbacks worth understanding, especially when it's raised too early in the life of one's venture.

Second, we in the academic community have learned that we can teach people to write business plans—which can be submitted as a pile of paper with a staple in the corner—and students will flock to us in droves! Never mind that one cannot really plan very well for a highly uncertain entrepreneurial venture, and that new-venture success most often arrives in the shape of Plan B or Plan Z, not the Plan A that has been so lovingly articulated in the business plan. We can teach them to plan (and we can teach them to pitch, too), so plan (and pitch) they will!

But the vast majority of fast-growing companies don't get their money this way. As we'll see in Chapter 1, there are compelling reasons why getting the funding you need from your customers is often a much better way to go.

**“the vast majority of fast-growing companies don't get their money this way”**

## The Solution: The Customer-Funded Business—An Idea Whose Time Has Come

In early 2012, I embarked on a research journey to develop a deeper understanding of the plucky entrepreneurs who build

great companies—sometimes small ones to fit their lifestyles, other times large ones that have become household names—and the methods (five of them, each different from the other) they’ve used to start and grow their businesses with their customers’ cash. The book you are now holding in your hand or viewing on your screen delivers the fruits of my journey.

But the book delivers much more than just my own insights and the evidence I’ve gleaned. It’s filled with the captivating stories of companies—Airbnb, Dell, Banana Republic, and many more—that have been built and financed this way (at least at the outset, though often not forever) and is brimming over with early-stage investors’ perspectives. As a result, the book makes what I believe is a compelling case for customer funding as the *first* approach that entrepreneurs—whether in garages or around kitchen tables or in well-established companies—should consider when funding their nascent businesses. And I’m not alone in this view. Some of today’s savviest investors share it, too!

Indeed, venture capital investor Fred Wilson of Union Square Ventures puts the folly of raising too much venture capital

**“The fact is that the amount of money startups raise in their seed and Series A rounds is inversely correlated with success.”**

too early in stark terms. “The fact is that the amount of money startups raise in their seed and Series A rounds is inversely correlated with success. Yes, I mean

that. Less money raised leads to more success. That is the data I stare at all the time.”<sup>3</sup> Two-time entrepreneur turned venture capitalist Mark Suster of Upfront Ventures is of a like mind. “I say ring the freaking cash register,” he says. “I have said so for years.”<sup>4</sup>

That’s what customer funding is all about at the end of the day, through any of the five ingenious ways I’ve uncovered to do it. Ring the cash register early enough and often enough and you’ll have the magic of customer traction—hence the funding—you need to get your fledgling business off the ground. Are Wilson, Suster, and I merely foolish or naïve? Or might we be onto something, even a customer-funded revolution, perhaps?

## Who Should Read This Book?

Given the global diversity of the entrepreneurs and their companies—from Europe, Asia, and North America—whose often inspiring stories bring this book to life, there are six key practitioner audiences worldwide for whom I have written this book:

- Aspiring entrepreneurs who lack startup capital but yearn for the freedom and joy that running one's own business provides.
  - Early stage entrepreneurs trying to figure out how to get their nascent but cash-starved ventures into takeoff mode.
  - Angel investors, who are often an entrepreneur's first port of call when seeking capital. *You* are this book's most important audience, perhaps, for you are the ones with the power to set the entrepreneurial vessel on a more sensible course. In fact, you're so important an audience that you'll find at the end of each chapter a checklist—John's Business Angel Checklist—of due diligence questions that *you* should ask entrepreneurs seeking your capital. If you can set straight some of each year's 5 million and more who seek your capital—and that's the number in the United States alone—you'll have made a really important contribution to tomorrow's entrepreneurial ecosystem. Better yet, I believe that in so doing, you'll win your entrepreneurs' thanks as well as preferential access to deals that have been de-risked through proven customer demand. I don't have to tell you what this can do for your investment returns!
- “you'll win your entrepreneurs' thanks as well as preferential access to deals that have been de-risked through proven customer demand.”**
- Those running the growing number of business incubators and accelerators, another set of early ports of call for aspiring entrepreneurs. Stop talking about how many of your startups successfully raise a Series A round, *please*, and start talking

about how many of them achieve early customer traction and are growing while still owning and controlling the majority of their businesses! Who kept a greater portion of the value his company created: Michael Dell or Steve Jobs? It was Dell, hands down, whose customer-funded story is told in Chapter 2.

- The fabled three Fs: the family, friends, and fools who back so many entrepreneurial ventures. I suggest you do your loved ones a favor and ask them to come back to see you when they've secured their first paying customers (yes, even before they've produced their first product!).
- Finally, let's not forget the potential innovators at the top of—or hidden in the nooks and crannies of—today's growth-starved companies. Though it is through stories of entrepreneurs and their companies that I deliver most of this book's lessons (sadly, according to venture capital investor Bill Joy, "Big companies almost never innovate. It's not that innovation itself is rare—it's occurring everywhere. Which means, mostly, elsewhere."<sup>5</sup>), the principles articulated in this book are for you and your company, too!

There's one other important audience I have in mind as well. I've also written this book for my fellow faculty who are teaching

**“I've also written this book for my fellow faculty who are teaching entrepreneurship and venture capital”**

entrepreneurship or venture capital in the world's growing number of business schools and other academic institutions offering vibrant entrepreneurship programs. Together we are creating

and empowering a new generation of entrepreneurs who are charged with creating virtually all of what will be our communities' net new jobs in the future. It's a crucially important role that we and our graduates must play in today's volatile and uncertain economic environment.

I suggest that we faculty all add a session to our business plan and entrepreneurial finance courses that offers customer funding as an alternative approach—in my mind, the *preferred* approach—to getting a young company underway. In doing so for your students yearning to start their own businesses, whether now or later, you will join me in getting them focused on customers, instead of investors. Once they have enough customers, the investors—if needed at all—will surely follow.

**“Once they have enough customers, the investors will surely follow.”**

## Why John Mullins? Why Now?

My two earlier books, the first (*The New Business Road Test*) on how to rigorously and systematically assess an entrepreneurial opportunity *before* you get started,<sup>6</sup> and the second (*Getting to Plan B*) on how to get to a business model that will actually work—and might just revolutionize your industry<sup>7</sup>—have prepared me well and set the stage for the unanswered question that this book addresses: “How can I best start, finance or grow my company with my customers’ cash, instead of that of investors?” But that’s not all.

Having started two entrepreneurial companies and worked at a third, and having served on the boards of numerous others, including successes and failures, I’ve accumulated the scars and bruises that are always the surest sign of learning. More than that, though, for more than two decades in this, my second career, as a business school professor, I’ve been fortunate enough to have had the time and resources to dig deeply into the “whys” and “hows” that underlie entrepreneurial success and failure. Simply put, I’m in the right place at the right time to have researched and written this book.

## In 60 Seconds or Less: The Elevator Pitch

My purpose in putting *The Customer-Funded Business* into your hands is to get entrepreneurs of nearly every kind to see that their

top priority in the early going—and often later, too!—is to find a customer who will pay you on good terms (often in advance), *not* to raise venture capital. To address this purpose, the book brings to life five customer-funded models and the key questions that should be asked in considering (Chapters 2 through 7) and pursuing (Chapter 8) each of them. It also addresses the key implementation questions that will surely arise:

- when to use which model
- how best to apply them
- what to watch out for—the pitfalls that lie along the way

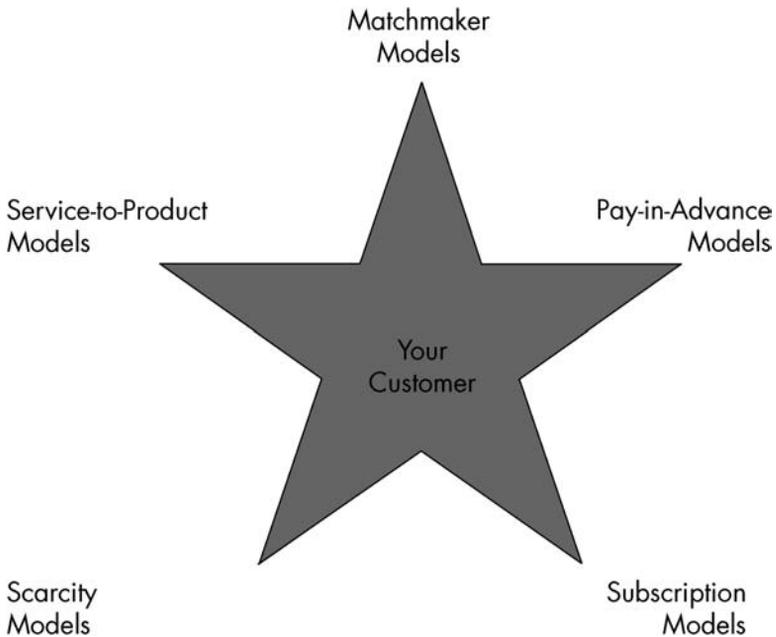
Whether you're an aspiring entrepreneur lacking the startup capital you need, an early-stage entrepreneur trying to get your cash-starved venture into takeoff mode, a corporate leader seeking funding to grow an established company, or an angel investor or mentor who supports high-potential entrepreneurial ventures, this book offers the most sure-footed path

**“this book offers the most sure-footed path to starting, financing, or growing *your* business.”**

to starting, financing, or growing *your* business or one you support. Are you intrigued? Ready to be inspired? If so, turn the page!

# 1

## Craving Crowdfunding? Pandering to VCs? Groveling to Your CFO?: The Magic of Traction and the Customer-Funded Revolution



Imagine this. It was 1995, and the Coca-Cola Company had just reentered India after an aborted earlier effort, this time by acquiring the maker of Thums Up, India's leading cola. Along with the deal came a thick book describing each of the Thums Up bottlers' territories in plenty of legal jargon, but without a single map. Coke needed a way to find and understand its newly acquired territories.

Alas, no one had maps that could show Coke where its bottlers were located. Until the mid-1960s, maps had been largely unavailable in India, at least for anyone not in the military. Even 30 years later, a mapping culture and map-reading ethos simply did not exist, perhaps in part because there were very few accurate Indian maps.

Into the breach stepped Rakesh and Rashmi Verma, who had started a small IT training business in India, CE Info Systems, serving blue-chip clients like IBM. Their company also licensed American digital mapping software to aid India's nascent map-

**“We can give you the maps you need.”**

making industry.<sup>1</sup> Saying to Coke, “We can give you the maps you need” (even though they had not actually ever produced a single map!), the Vermas began to build a digital mapping business. First, they bought an ordinary office scanner and took out the kitchen scissors. Next, using their native Indian ingenuity, they began cutting what rudimentary paper maps they could find into A4 size and scanning them to make them “digital.” Using Rashmi's software and programming skills together with the American software they had been licensing to others, they then overlaid demographic and other data to enable Coke—and soon other commercial customers—to do in India what they took for granted in other parts of the world.

CellularOne, entering India in a joint venture with Essar as the Indian telecommunications industry was liberalized, was their next client. “Where should we put our mobile phone towers?” CellularOne asked, from both a technical perspective (Where is the high ground? How do we achieve uncluttered line-of-sight

coverage in Bombay, a city of high rises?) and from a marketing perspective (Where are there sufficiently dense concentrations of customers with the right demographics whom we can economically serve?). Once again, the Vermas delivered.

## A Customer-Funded Model

So, did the Vermas need venture capital to start, finance, and grow their business? No. Instead, they identified customer after customer—even the Indian Navy—who could benefit from digital maps, charging the customers fees to cover most of the development costs of creating additional maps or applying additional demographic or other information to maps they had already created. Over the next 10 years, their mapping business grew slowly but steadily, funded by one customer assignment after another, and they became the dominant digital mapmaker in India. And they did so without raising a single rupee of venture capital.

The Vermas weren't doing anything radically new in shunning venture capital. To be realistic, such capital probably would not even have been available in India in the mid-1990s. But by funding the early growth of their business with their customers' cash, they were simply doing what most entrepreneurs did before business angels and venture capital investors grabbed the entrepreneurial finance spotlight more than a generation ago in the West, and today nearly everywhere else.

**“The Vermas weren't doing anything radically new in shunning venture capital.”**

## Customer Funding: The Vermas Are Not Alone

What the Vermas accomplished with customer funding is neither unique to India nor to the 1990s. Anyone who has booked a

hotel room on Expedia.com, for example, might be surprised at the role they were playing in funding Expedia's operations and growth. Not only didn't Expedia pay the hotel for your stay until after you arrived—despite the fact that you probably paid Expedia when you booked the room—but in many cases they paid the hotel as many as six weeks *after* your stay. What is Expedia doing with your money—their customers' money—for all those weeks, or sometimes months? Running and growing their business, of course! “Sitting on the float” with the customer's money is a time-honored principle that runs throughout this book.

As we'll see in Chapter 2, starting, financing, or growing your business with your customers' cash isn't novel. It's a fundamental principle—a mind-set, really—by which many entrepreneurs live. It's how Michael Dell created one of the twentieth century's most prominent success stories and how Mel and Patricia Ziegler created Banana Republic, another customer-funded phenomenon. In the five chapters that then follow, equally remarkable are the stories, all customer funded, of Airbnb (Chapter 3), Threadless (Chapter 4), India's TutorVista (Chapter 5), Gilt Group (Chapter 6), Denmark's GoViral (Chapter 7), and nearly a dozen other inspiring companies—plus some failures as well—and the entrepreneurs who created and drove them. Whether you're an entrepreneur or a leader in an established business that wants to grow faster, you get the drift: The customer-funded business has been a widely practiced phenomenon, but has been underobserved and underdiscussed. But not any more!

## A Problem: Financing Your Startup

Later in this chapter, I'll explore in some depth why I believe raising equity at the outset of a new venture's journey is, at least most of the time, an exceedingly bad idea—for both

entrepreneurs and investors alike. For now, though, think of it this way:

- Most of the time, the Plan A that you have so lovingly conceived is unlikely to work, as most any experienced early-stage investor, whether a VC or a business angel, will tell you. Do you look forward to explaining to your investors why your Plan A didn't work, as you ask them for more money for your newer, brighter, and inevitably still-optimistic Plan B? I don't think so! As Peter Drucker, arguably the leading management thinker of the twentieth century, observed, "If a new venture does succeed, more often than not it is
  - in a market other than the one it was originally intended to serve
  - with products and services not quite those with which it had set out
  - bought in large part by customers it did not even think of when it started
  - and used for a host of purposes besides the ones for which the products were first designed."<sup>2</sup>
- There are material drawbacks to raising capital too early. Among the most daunting of them is that raising capital—whether by pandering to VCs or groveling to your CFO, if you're seeking to start something inside an established company—is a full-time job. Getting your venture underway is a full-time job, too. If you try to do both, one of them will inevitably suffer.
- As you'll see later in this chapter, the evidence is compelling that the odds of success for VC-backed companies are far worse than most entrepreneurs realize. Is joining tomorrow's

**“Do you look forward to explaining to your investors why your Plan A didn't work?”**

failure statistics what you had in mind in pursuing your venture? Definitely not!

## A Solution: The Magic of Traction

Fortunately, with the cost of technology declining ever more rapidly, it's easier and cheaper to get into a customer-funded business than ever before. As this book will make clear through the companies whose stories it tells, there are numerous benefits that all five customer-funded models provide, to entrepreneurs and their backers alike.

- First, waiting to raise capital forces the entrepreneur's attention toward his or her customers, where it should be in the first place. Customers matter, and as Peter Drucker also

**“if there's no paying customer—at least eventually—there's no business, either”**

noted, if there's no paying customer—at least eventually—there's no business, either (the protestations of some dot-com entrepreneurs to the contrary).

- Second, winning customer orders often gives your customer a vested interest in your success. If they are happy to buy from you, they'll want you to stick around, either so they can buy again later, or so you will service what you've sold. For an entrepreneur, having your customers on your side is a good place to be. For angels, having customers rave about the company in which you are thinking of investing is a very good sign!
- Third, making do with the probably modest amounts of cash your customers will give you enforces frugality, rather than waste. Having too much money can make you stupid and lets you ignore your customer! Having less money will make you smarter, and will force you to run your business better, too.

- Fourth, when venture capital is raised later, once customer traction is proven, the investor's risk is lower, meaning the terms and valuation are better, and making the founder's stake—and perhaps control—more substantial, too. For angels, investing later reduces the number of eventual “lemons” in the portfolio and is likely to improve returns.
- Fifth, focusing your efforts to raise cash from customers who are willing and eager to buy from your yet-unproven company is likely to mercifully put to rest a half-baked or not-quite-right idea that requires more development—a pivot, in today's entrepreneurial lexicon—in order to hit the mark.
- Finally, there's freedom! Gaining one's freedom is high on every entrepreneur's priority list, and the best source of freedom—even better than cash in the bank—is positive cash flow! And with the magic of customer traction and the cash flow it brings, you'll sleep better, too!

**“The best source of freedom—even better than cash in the bank—is positive cash flow!”**

These benefits accrue largely to startups or early-stage ventures, along with their possible investors, of course. “But what about me?” you may ask, if you're in a well-established company with customers—perhaps slow-paying customers—already in hand. Ryzex, a purveyor of mobile computing devices (like the handheld gadgets your gas utility uses to read your meter, your FedEx driver brings with your parcel to your door, or a supermarket clerk uses to order more of what's running low), faced a difficult challenge as the global financial crisis landed on its doorstep with a thud in the fourth quarter of 2007. Says Ryzex founder Rud Browne about oncoming recessions, “The canary in a coal mine is computer hardware sales. It's the first thing a business can stop spending money on. A huge percentage of the new capital equipment (machinery, vehicles, computers) bought

by businesses each year is purchased to replace equipment they already have and typically replace on a three- to seven-year cycle. The easiest way to conserve money in a crisis is to extend the replacement cycle of stuff you already have. When this happens, suppliers like Ryzex immediately experience a significant drop in revenues.”<sup>3</sup> For the Ryzex story and how customer funding built a thriving company and then got it through a daunting downturn more or less unscathed, see Sidebar 1.1.

### **Sidebar 1.1: Customer Funding Helps Ryzex Thrive, Then Survive**

In its early days, Ryzex bought decommissioned mobile-computing equipment that was sitting in warehouses gathering dust and sold it to business users who needed to expand their existing fleets. When users added another few trucks or new stores, they generally wanted to buy exactly the kind of mobile devices they already were using, around which their systems had been built. Often, however, the exact such devices were no longer being made. Ryzex would find them used and—because they were gathering dust anyway—buy them, generally on 90-day terms. Ryzex then refurbished and sold them, with the customer paying in advance, or worst case, in cash on delivery.

Thanks to the 90 days or more of customer cash these buying and selling practices provided and its attractive gross margins (from buying used equipment for a song and selling it dear to customers who sorely needed it), Ryzex grew from a standing start in a tiny apartment in Vancouver, British Columbia in 1989 to \$75 million in sales in 2007, with 360 people in offices spread across five countries. The arrival of the Internet was putting pressure on margins, however, and migration to larger corporate customers and the sale of new equipment, too, had put pressure on Ryzex’s

pay-in-advance terms. So in early 2008, Ryzex found itself with plummeting sales, declining margins, and \$3 million in debt. The global financial crisis was, for Ryzex, a crisis indeed.

Ryzex founder and CEO Rud Browne went into high gear. Personally training each and every one of his 360 employees on the importance of cash flow, Ryzex made managing cash everybody's job, whether that meant getting longer payment terms from its vendors or faster payment from its customers. "On the customer side, there was no single bullet," recalls Browne. But there were several customer funding strategies that dramatically improved his company's cash flow:

- When customers wanted extra discounts (which they almost always did), granting discounts was tied to pay-in-advance or seven-day terms. "We would have had to go to the lower price anyway," Browne recalls. "So we made sure we got something for it—better terms."
- Ryzex ramped up its sales of one-year service and maintenance contracts paid in advance, instead of monthly in arrears. It also ramped up sales of vendor-provided service contracts, for which Ryzex needed no investment in parts—inventory that may take 12 months to turn, thereby further conserving precious cash.
- While everyone in the industry felt tremendous pressure to accept every purchase order, Ryzex remained disciplined and simply refused to extend credit to customers it deemed financially risky. "We'd rather take a hit to our sales than have them go belly-up," says Browne. Internal resistance to this policy evaporated when, after having insisted on prepayment, Ryzex avoided losing \$1.5 million when one customer went bankrupt a week after the goods were delivered.

*(continued)*

### Sidebar 1.1: Customer Funding Helps Ryzex Thrive, Then Survive (*continued*)

- Ryzex encouraged its customers, many of which were also cash starved, to use equipment leasing to finance large purchases. The leasing companies would pay Ryzex in 72 hours. Ryzex would pay its vendors (within agreed terms) 45 to 60 days later.

Ryzex even began printing its invoices on garish, bright-green paper. “It’s the ugly green one,” its accounts receivables clerks would say to their customers when they claimed they couldn’t find the Ryzex invoice.

Despite a 25 percent drop in sales and a 50 percent drop in margin dollars as the recession deepened, by applying these strategies as well as others in the cost and procurement arenas, Ryzex went from having \$3 million in debt to a \$6.5 million cash surplus in just 17 months.

Do customer funding principles such as these apply to companies like yours? Just ask Rud Browne. Indeed, they do!

*Source:* Rud Browne, interview with the author, December 2, 2013.

## Customer-Funded Models: The Five Types

In an effort to better understand customer-funded models, the circumstances and ways in which today’s entrepreneurs can best put them to use, and the challenges entailed in implementing them, my research uncovered five different types of models—each surprisingly familiar when you think about them carefully—through which founders have convinced their customers to fund their companies, particularly at startup (see Table 1.1 and the appendix, “About the Research”).

**TABLE 1.1** Customer-Funded Models – The Five Types

<b>Type</b>	<b>Category-Defining Examples</b>	<b>Twenty-First-Century Examples</b>
Matchmaker models	Real estate brokers, eBay, Expedia.com	Airbnb, DogVacay, ProFounder
Pay-in-advance models	Consultants, architects, Dell, Banana Republic	Via.com, Threadless, The Loot
Subscription models	<i>Wall Street Journal</i> , <i>Financial Times</i> , Showtime, Netflix	TutorVista, H.Bloom
Scarcity-based models	Zara	vente-privee, Gilt Groupe, Lot18
Service-to-product models	Microsoft	MapmyIndia, Rock Solid Technologies, GoViral

What is most striking about these models is that each of them gives the company what accountants call negative—or very nearly 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 sells. In exploring these models, I found that most of them—perhaps surprisingly—work for selling both goods and services. Let’s define the five models.

### **Matchmaker Models**

Some companies are in the business of matching up buyers and sellers, such as your local real estate broker, eBay, or Expedia. Because they simply take the order, but never own the goods (somebody’s home or junk from your attic) or services (airline tickets or hotel rooms) that are sold, there’s no need to tie up cash in inventory. The fees or commissions they earn from customers—whether from buyers, or more typically, sellers—

provide most or all of the cash required to launch the business and grow it enough to prove the concept, and sometimes take it

**“matchmaker models are those in which the business, with no or limited investment up front, brings together buyers and sellers—without actually owning what is bought and sold.”**

much further. Thus, matchmaker models are those in which the business, with no or limited investment up front, brings together buyers and sellers—*without* actually owning what is bought and sold—and completes the transaction, earning fees or commissions for doing so.

We examine matchmaker models in Chapter 3. Perhaps the most inspiring of our case histories that bring matchmaker models to life is that of Airbnb, which has grown from its 2007 start—on a couple of airbeds on the floor of founders Joe Gebbia and Brian Chesky’s San Francisco apartment<sup>4</sup>—to a global booking system that monetizes people’s extra space. As I write in late 2013, Airbnb offers more than half a million properties in 34,000 towns and cities in 192 countries.<sup>5</sup>

### Pay-in-Advance Models

In some industries, customers traditionally pay the supplier in advance for at least part of the price of goods or services *before* receiving anything. Consultants, architects, and many kinds of

**“pay-in-advance models are those in which the business asks (and convinces!) the customer to pay something up front.”**

other services firms are good examples. Thus pay-in-advance models are those in which the business asks (and convinces!) the customer to pay something up front—perhaps a deposit, perhaps something structured in another way, perhaps

the full price—as a requirement to get started on building or procuring whatever it is that the customer has agreed to buy.

We examine pay-in-advance models in Chapter 4. The amazing story of little-known Via.com, the “Intel Inside” of

the Indian travel industry, shows how a plucky entrepreneur named Vinay Gupta started a business using his customers' deposits and grew it from scratch in 2006 into India's largest travel business by 2013, with more than half a billion dollars in sales.<sup>6</sup> Its pay-in-advance model has served Via, and its travel agent customers, very well!

### Subscription Models

There's nothing new about subscription models, of course, wherein a subscriber pays for something—the *New York Times* or Showtime, for example—and the goods or services are then delivered over an ensuing period of weeks, months, or years. Sometimes the subscription fee is paid entirely up front, as I do with my subscriptions to various periodicals and journals, and sometimes they are paid on a recurring basis—typically the case with cable TV. Thus subscription models are those in which the customer agrees to buy something that is delivered repeatedly over an extended period of time—perhaps a product, like newspapers or a box of organic veggies delivered weekly straight to your door—or a service like a cable TV subscription or your monthly Netflix fix. Or, as we saw in the Ryzex story, even a maintenance contract to make sure Ryzex customers' mobile devices—or our laptops or fridges—will be fixed at no cost if they fail.

**“subscription models are those in which the customer agrees to buy something that is delivered repeatedly over an extended period of time”**

We examine subscription models in Chapter 5. Perhaps the closest to home (literally!) of the case histories in the book is that of India's TutorVista, which helps more than 10,000 students per month around the world with their homework in their own homes. Starting with three Indian tutors and an online erasable whiteboard over a VoIP connection in 2005, Krishnan Ganesh built a company that was sold to Pearson PLC, the world's largest

education company, at a \$213 million valuation in 2011.<sup>7</sup> From zero to \$200-plus million in six years: a testament to the remarkable value creation potential of companies built on customer-funded foundations.

### Scarcity Models

These days, innovative specialty retailers of various kinds are using scarcity models to achieve rapid inventory turnover that gives them negative working capital: that is, the customers buy the goods before the retailers' vendors are paid. In effect, the retailer

**“scarcity models are those in which what's for sale is severely restricted by the seller to a limited quantity for a limited time period, with the seller's supplier being paid *after* the sale is made”**

finances its business using your and my money. Thus scarcity models are those in which what's for sale is severely restricted by the seller to a limited quantity for a limited time period, with the seller's supplier being paid *after* the sale is made.

When the goods are gone, they're gone, and there will be no more! In scarcity models, the scarcity is typically reflected in both the paucity of units offered for sale, typically with no reorders, and in the brief time period during which those units are available.

We examine scarcity models in Chapter 6. Imagine selling high-fashion but overstocked Parisian apparel that people didn't want and turning the business into one of France's best-known brands. That's exactly what Jacques-Anton Granjon and his founding team did with *vente-privee*, the originator of the flash sales concept for moving surplus fashion merchandise. Connecting the dots in 2001 between the founders' prior experience of discreetly moving unwanted inventory for high-profile brands, and the Internet's ability to create a virtual store that could move volumes of discounted merchandise without disrupting the brands' carefully honed images, Granjon and his team pioneered a new industry—flash sales—and grew *vente-privee* into a

business selling more than 200,000 items each day to its more than 18 million members across eight European countries by 2013.<sup>8</sup> Alas, as we shall see in Chapter 6, not all of *vente-privee*'s flash sales imitators have fared very well.

### Service-to-Product Models

At the dawn of the personal-computing age, Bill Gates and Paul Allen won a contract from IBM to provide an operating system for its new personal computer. Their company, Microsoft, also won similar contracts to develop and deliver operating systems for other PC makers as that market exploded in the 1980s. Eventually, Microsoft began delivering software-in-a-box—the now ubiquitous Word, Excel, and other Microsoft products—thereby transforming its services business into one that shipped “products” that were ready to use. Thus service-to-product models are those in which businesses begin their lives by providing customized services and eventually draw on their accumulated expertise to deliver packaged solutions that stand on their own.

**“service-to-product models are those in which businesses begin their lives by providing customized services and eventually draw on their accumulated expertise to deliver packaged solutions that stand on their own”**

Sometimes the products are delivered in physical containers, sometimes as software-as-a-service (SaaS) digitally downloaded to our PCs, iPads, or mobile phones—ready to be used or consumed by the customer largely without seller support.

We examine service-to-product models in Chapter 7. The story of how Danish entrepreneurs Claus Moseholm and Jimmy Maymann built GoViral into the world's largest distributor of branded video content without *ever* taking a krone of external capital—and then sold the company in 2011 for 500 million Danish kroner (about \$97 million),<sup>9</sup> a feat that took less than

eight years—makes Moseholm and Maymann the most inspiring poster children and role models for the potential of customer-funded businesses.

## What Customer-Funded Models Have in Common

Regardless of their type or the eventual size to which they have grown—some incredibly large, some not so large; some successful, others not—our examples of companies using customer-funded models share three attributes:

- They required little or no external capital to get started.
- At founding, most were what in today's entrepreneurial parlance would be called lean startups. For more on how today's lean startup movement and customer funding go hand in hand, see Sidebar 1.2.
- Most of them raised institutional capital eventually, and did so once the concept had been proven.

### **Sidebar 1.2: Lean Startups—Raising the Bar**

In today's lean startup world, testing one's initial idea in an experimental fashion is the name of the game. Many such early tests involve figuring out whether what is being offered—the search for a minimum viable product (MVP), in lean startup lingo—is what the customer will buy. Applying any of the five customer-funded models raises the lean startup bar. How? It sets the standard not as what

the customer *says* he or she or the business will buy, but what they *actually buy and pay for*, typically in advance! Thus, adopting any one of the five customer-funded models from the get-go should be the first option for getting any lean startup underway. When your target customer writes you a check for your MVP or a refinement thereof, you know you are on to something good!

On the flip side, putting entrepreneurial ideas to rest, or altering them earlier—thus failing early, and failing small—and moving on to better ideas, is a defining characteristic of many of today's most successful entrepreneurs. If you can't get a customer to pay for your MVP, maybe it's time for a pivot. When a customer drives the pivot, and subsequently pays for what you come back with—in advance, through one of the five customer-funded models—that pivot will have been proven to have made good sense.

Further, we observed that, in almost every case, there was at some point a queue of VCs lined up, eager to invest. Contrast that with the length of the typical queue that early-stage entrepreneurs find at their door: nil. Or, if they're really lucky and some investor shares their vision, one. Unfortunately for the entrepreneur, when there's a queue of one, it's the investor who calls the shots on the deal. Since the *successful* application of any of the five customer-funded models *always* results in customer traction, there's a far higher likelihood of eventually having a queue of VCs at your door if, at some point, you decide to raise capital to grow your then-proven venture faster.

“**the *successful* application of any of the five customer-funded models *always* results in customer traction**”

## Craving Crowdfunding? What This Book Is—and What It's Not

First, this book isn't about how to “bootstrap” your business, a topic on which much has been written.<sup>10</sup> Bootstrapping generally connotes making do with less—sales and marketing on a shoestring, being thrifty, borrowing or sharing instead of buying, and the like, though some bootstrapping proponents also emphasize the sorts of customer-funded financing strategies that are much more fully developed in this book.<sup>11</sup> Bootstrapping principles, when they coexist alongside the use of customer-funded models, can be important contributors to enabling an entrepreneurial venture to proceed a long way down the road before raising capital. But, as bootstrapping is well covered elsewhere, you won't find these principles addressed here.

Second, there's Kickstarter, plus Indiegogo and the rest of the 138 crowdfunding websites up and running, in the United States alone, in 2012, not to mention their imitators springing up all over the world.<sup>12</sup> This book isn't about crowdfunding, either, though that phenomenon is an example—the tip of a much larger iceberg, if you like—of one kind of customer-funded model that this book explores, including that of the now-defunct Pro-Founder, whose unfortunate case history is told in Chapter 3. If you are craving crowdfunding, there's no shortage of books on that topic, too.

“Why doesn't this book address crowdfunding?” you may ask. After all, by mid-2012, more than 50,000 projects had been listed on Kickstarter alone, of which something like half had reached their (typically very modest) fundraising goals, and by early 2014 Kickstarter passed the \$1 billion milestone in amounts pledged.<sup>13</sup> One Kickstarter-funded project, the film *Inocente*, won

**“Why doesn't this book address crowdfunding?”**

an Academy Award in 2013.<sup>14</sup> Even crowdfunding failures deliver value to their proponents, argues Ben Redford of the London-based design agency Mint Digital. If a project fails to reach its funding goal, that's "brilliant," he says, "because I (or he or she) didn't make something that nobody wants."<sup>15</sup>

On average, though, crowdfunding projects, many of which have more to do with artistic or cultural projects than for-profit businesses with growth potential, have raised very modest sums. On Kickstarter only 30 had raised more than \$1 million as of mid-2012. Says Kickstarter co-founder Yancey Strickler, "The typical project raises five grand and is supported by 85 people."<sup>16</sup> Evidence from research firm Massolution provides additional and wider evidence of the very modest sums typically raised: more than 1 million campaigns have generated some \$2.7 billion in funding to date, an average of less than \$2,700 per campaign.<sup>17</sup>

Generating these modest outcomes takes lots of work. Crowdfunding projects that do well often have prototypes already developed, typically use professionally produced videos, and usually bring their own "crowds"—the proverbial friends, family and fools (or followers)—who, perhaps with their extended networks, actually contribute most of the funds. According to crowdfunding author Dan Marom, "The entrepreneur herself attracts most of the investment by mobilizing her own social network. That is, the pool of backers is not predominantly provided by the platform."<sup>18</sup> Indeed, data from Kickstarter suggest that, of those who invest in Kickstarter projects, some 85 percent do so only once.<sup>19</sup> Of course, launching a crowdfunding campaign is only the beginning. Savvy proponents then update their backers regularly with progress reports. For an example of an equity-based crowdfunding project that worked, at the time setting a European record for a crowdfunding campaign for a pure startup, see Sidebar 1.3.

**Sidebar 1.3: Pizza Rossa—A Crowdfunding Campaign That Worked**

Corrado Accardi was tired: tired of angel investors asking for too much of his company and tired of too many onerous terms. “First they say they love you. Then they tell you the terms,” he recalls. His banker also wanted onerous terms: the Accardis’ home as collateral, not exactly what Accardi’s wife, Tiziana, not to mention Accardi himself, had in mind.

Fortunately, Accardi had already secured commitments of £200,000 from a varied collection of family and friends for his proposed London takeaway pizza concept, Pizza Rossa, but he needed £280,000 to get started. Ideally, he hoped to raise £430,000 to enable him to roll out the first two of a dozen planned outlets—plus a commercial kitchen to support them—across central London. He wondered whether crowdfunding might be the answer to raising the rest of the funds he required.

By studying the campaigns of other businesses that had met their crowdfunding targets, he observed some patterns from which he thought he could learn:

- Nearly every campaign that reached at least 35 percent of its target was eventually successful in reaching the 100 percent mark. “I’m already past 40 percent of my £430K goal,” he figured. “I can bring my own crowd!”
- There was more activity on weekends than on weekdays.
- Every campaign was marked by spurts of activity, followed by lulls. “Momentum seems to matter,” he observed. “Can I use my existing commitments judiciously to ensure that my momentum picks up whenever it starts to die away?”

Accardi launched his campaign on London’s Crowdfunder with a professionally produced video on a Friday,

inviting *some* of his friends and family—but not all, holding back others for managing momentum as his campaign settled in—to give his campaign a good start. By the end of the first weekend, his campaign had logged 27 investors and £152,000 in commitments. When things then went quiet early in the week, he called a few of his pre-committed investors, saying, “It would be great if you could invest NOW!”

After 18 days Accardi had reached his minimum figure of £280,000, but he wanted more. An overseas investor wanting to invest over £100,000 approached him, seeking better terms, plus franchise rights to Brazil. After a tasting session in London, the deal was sealed, with the better terms (but not the rights to Brazil!) then offered retroactively to all the earlier investors. At £380,000, Accardi was nearly there. As the campaign approached its target, he contacted everyone who had inquired: “You’d better invest now, or we’ll be sold out!” In the final four hours of the campaign on day 19, he raised £150,000. His campaign—raising the most money ever in the UK for a crowdfunded startup—attracted some 12,000 views, from which 122 individuals invested, including Accardi’s original investors. When crowdfunding is managed adroitly, it can be a good way to go!

*Source:* Corrado Accardi, interview with the author, November 20, 2013.

So why does this book give only modest attention to this fast-growing and possibly lucrative phenomenon? “While Kickstarter has helped people make things, everything else still needs to be figured out,” observes Yves Behar, founder of the design consultancy Fuseproject in San Francisco.<sup>20</sup> Indeed, adds Brady Forrest, who runs a startup accelerator in San Francisco, “There is a big difference between being a product and being a company.”<sup>21</sup> There’s the rub.

This book is concerned with creating and building fast-growing companies through the use of customer-funded models. While a successful crowdfunding campaign—like Corrado Accardi’s Crowdcube campaign in the UK—can mitigate some of the drawbacks of raising capital too early, customer traction from the crowd lacks both the credibility and repeatability of customer traction from those whose problems your business will actually solve going forward. Crowdfunded money from your family and friends—and, if you are lucky, their networks—is often provided for quite a different reason than the fundamentals of the idea: They love you, but real customers may not! As I write in late 2013, Accardi does not yet really know whether Londoners will buy the pizza that Pizza Rossa eventually offers, so consumer response to his business, though not his fund-raising prowess, remains an open question. As we’ll see in the captivating case histories that comprise the heart of this book, developing and systematically applying customer-funded models involves much more than raising funds, and brings benefits that far exceed what crowdfunded money typically brings.

Thus the jury on crowdfunding is still out. It remains to be seen whether the phenomenon will evolve into an enduring way to raise startup equity or debt, in addition to its role in raising donations or other money in return for in-kind benefits—a T-shirt, a beta version of the proposed product, or whatever—given to contributors. Such offers are where most of the crowdfunding activity has focused to date. Despite supportive legislation in the United States—President Barack Obama’s JOBS Act—in 2012, and Accardi’s UK success notwithstanding, regulators in most countries have yet to figure out how to make equity-based crowdfunding a reality on a large scale.<sup>22</sup>

**“We think that you shouldn’t start with the assumption that you need to raise money.”**

So if *The Customer-Funded Business* isn’t about bootstrapping or crowdfunding, what is its purpose? As TechStars co-founders and authors David Cohen and

Brad Feld observe, “We think that you shouldn’t start with the assumption that you need to raise money . . . Huge companies have been created with little or no outside investment.”<sup>23</sup> “Okay, that’s easy for Brad Feld or David Cohen to say, or for Bill Gates or Michael Dell to do,” you might be muttering to yourself. “But how might I do it for *my* company?” This book’s purpose is to provide the answer: five customer-funded models that inventive, creative, and motivated entrepreneurs in raw startups or executives in established companies can put to use to start, finance, or grow their companies and thereby satisfy their dreams.

## Raising Capital Too Early: The Drawbacks Explained

In the first portion of this chapter, I touched on some of the reasons why raising capital too early is, in my view, an exceedingly bad idea.

**“Raising capital too early is, in my view, an exceedingly bad idea.”**

Here I’d like to dig deeper into the drawbacks of doing so, just to be certain the point is driven home. It’s an important issue for the entrepreneur *and* for prospective investors because these days, people starting new ventures, whether inside large companies or in their garages, often assume that the first thing they must do is raise capital to fund their startup. “A great idea plus some capital and, voilà! We (and our investors) will soon be rich!” Or so they believe. But there’s something wrong with this picture that the Vermas and Ryzex’s Rud Browne intuitively understood.

As you can see in Table 1.2, there are significant drawbacks to raising capital too early (or ever, for some!).

- Raising capital demands a lot of time and energy, distracting entrepreneurs from building the actual business.
- Raising capital too early means pitching the merit of the business idea to potential investors, rather than proving its merit among customers in the marketplace.

**TABLE 1.2** Some Drawbacks of Attempting to Raise Capital Too Early

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A distraction	Raising capital often requires full-time concentration, but so does starting an entrepreneurial business. One or the other will suffer when investment capital is sought. Why not raise money later when the business is less fragile?
Pitching vs. proving merit	Nascent entrepreneurial ideas, however promising, always raise numerous questions. <i>Proving</i> the merit of your idea (to yourself and to others), based on accumulated evidence and customer traction, is much more convincing than using your own wisdom and charm to <i>pitch</i> its merit.
Risk	The further you progress in developing your business, the lower the risk, as early uncertainties become more certain. Less risk translates into a higher valuation and a higher stake for the founding team.
Baggage	The terms and conditions attached to institutional capital are (for good reason) onerous, as investors seek to protect themselves from downside risk. The further along the path, the less onerous the baggage.
Difficulty	Raising capital, even in the best of times for the best of ventures, is a difficult task! Why make it even harder by trying to do it too early?

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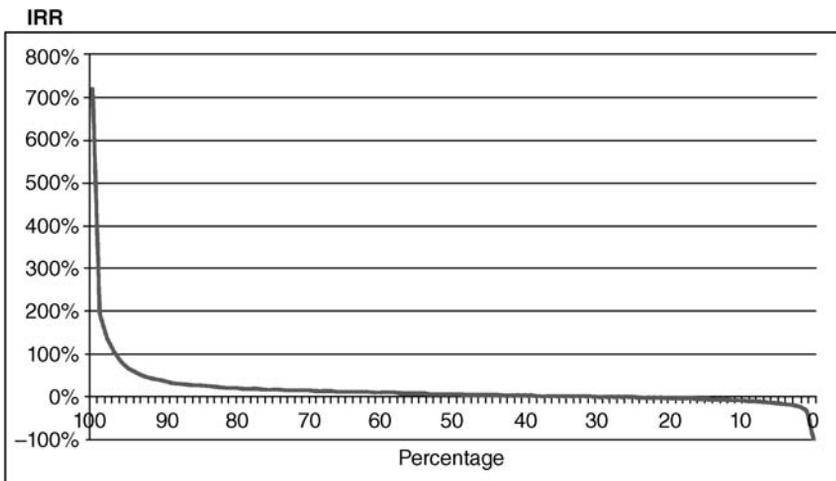
- Raising capital early leaves the founder with a lower ownership stake, since most risks and unknowns are still unresolved. In return for their capital, investors require significant stakes in businesses whose future is highly uncertain.
- Raising capital early brings lots of baggage: tough terms and conditions that investors rightly require to offset the risks they take by backing the venture.

- Raising capital is almost always very difficult, and may not even be possible, particularly under difficult economic conditions!

## An Even Bigger Drawback: Bad Odds!

There's another reason—a more dramatic one—why raising venture capital for a startup is not such a good idea. It is graphically shown in Figure 1.1. Angel investors, please note!

Lerner's graph shows the returns generated from virtually *all* American venture capital funds from the beginning of time through 2011. He's plotted the return of each fund in order, from best to worst. Those delivering the best returns are at the upper left-hand end of the graph (north of 700% return on the funds invested!), and those delivering the worst returns are at the lower right-hand end (the worst of them lost 100%—yes, *all*—of their investors' funds!). This graph tells us some things



Returns from inception to 12/31/11

**FIGURE 1.1** Historical U.S. Venture Fund Returns

Source: Josh Lerner analysis of Thomson/Reuters VentureXpert data.

that should be of considerable interest to those considering venture capital to fund their business:

**“This graph tells us some things that should be of considerable interest to those considering venture capital to fund their business.”**

- Do most VCs deliver good returns? No! About three-quarters of VC funds (the left and center portions of the curve, where the line sits above the zero return line) deliver *at least some* return, but more than half (those in the midsection of the curve) deliver no better than low single-digit returns; many others (those at the far-right end of the curve) lose some or all of their investors’ money.
- What portion of VC funds deliver decent returns? It depends on what one thinks of as “decent,” of course, but let’s say an annual return (internal rate of return, or IRR) in excess of 30 percent on the investors’ capital is decent, given the risky nature of VC investing and the typical 10-year period for which investors’ funds are committed. Only 10 percent of all funds deliver returns that are that good or better (the far-left portion of the curve). The other 90 percent don’t. Lower the bar to a 20 percent IRR threshold, and only about 20 percent of all funds deliver. Lower the threshold to a 10 percent return, and still, fewer than half of all funds meet the test. Why not? There are many reasons why most VC funds deliver poor returns, but among them are these:
  - Many VCs have never themselves built an entrepreneurial business or learned to deal with the entrepreneur’s inevitable challenges. Despite their best intentions, they don’t really know how to help an entrepreneurial venture succeed.
  - Some lack the depth and breadth of networks that can be genuinely helpful in building a business.
  - Some tend to pour too much money into a still unproven Plan A, in a race to “get big fast” (as we’ll see in Chapter 6).

- Some are like lemmings, following one another into the latest investment fad (as we'll see in Chapter 5). The latecomers often get burned.
- More fundamentally, it's really difficult to generate attractive returns by investing in entrepreneurial companies. Lest we forget, most entrepreneurs don't do so, either!

What do you get from VCs alongside their money? “Advice,” of course. How good do you expect that advice will be from those managing the funds occupying the middle and right-hand end of Lerner's curve? Given their not-very-good performance at managing their funds—which derives directly from the performance of the portfolio companies in which those funds were invested—you would be forgiven if you wondered just how good their advice is likely to be. Unfortunately, the terms under which they'll invest in your company means you likely will have to follow their “advice.”

There's one more fact that Lerner's graph does not show, and it's important, too. In the typical *successful* fund, the ones at the upper-left end of the curve, only 1 or 2 in 10 of the portfolio companies—the Googles and Facebooks and Twitters of the world—will actually have delivered attractive, sometimes stunning, returns. A few more portfolio companies may have paid back some or all of their invested capital, but the rest—as many as half of the companies, in a typical successful fund, and perhaps all of them in the funds toward the right end of Lerner's curve—are wipeouts. In the VC game, the few winners pay for the losses of the rest. Facebook alone accounted for more than 35 percent of the total VC exit value in the United States in 2012.<sup>24</sup> Thus, of the promising entrepreneurial *companies* that successfully raise venture capital, only a precious few actually deliver successful performance. Are these the kind of odds with which you'd like to play? Maybe there's a better game that has better odds: the customer-funded rather than the VC-funded game.

If you are a business angel reading this chapter, Lerner's graph should give you reason to pause. "Are angels' returns

**“If you are a business angel reading this chapter, Lerner's graph should give you reason to pause.”**

equally skewed?" you may wonder. There's been no comprehensive analysis to answer this question, unfortunately. But I expect the answer is a resounding

"Yes," and perhaps even more so. Your task, then, as an investor, is simple, in concept. Just find your way to the upper-left end of the curve. Easy to say, but difficult to do!

I believe one way to do so, though, is to focus your investment activities on businesses with customer-funded models or to convince those who seek your capital (and your advice!) to employ such models. After all, investing your money in companies with demonstrated customer traction is much less risky than investing in the bearer of a 40-page business plan and some slick PowerPoint slides! The magic of traction is no secret, of course. But you and your fellow business angels, together with the growing number of incubators and accelerators, can be among the most important actors in driving change—away from investors as the entrepreneur's first port of call, and toward the customer and the funding he or she provides.

## So, Why Now? Is a Customer-Funded Revolution at Hand?

Let's be candid. Raising capital, even in the best of times, isn't easy, and recent years have not been the best of times for entrepreneurs to raise capital. Venture capital funds have been shutting their doors right and left, which should come as no surprise to those at the far right-hand end of Josh Lerner's curve (see Figure 1.1). In 2011, U.S. venture capital investments into portfolio companies were off by more than 70 percent from their 2000 peak, just before the dot-com bubble burst.<sup>25</sup>

Capital flows *into* VC are off sharply, too, having fallen practically everywhere, with the underlying investors, the VCs'

limited partners, having cut their allocations to the VC asset class by half during the global financial crisis of 2008–2009.<sup>26</sup> Sadly, for VCs and for entrepreneurs seeking capital, things have not changed. As London-based Dawn Capital’s managing partner Haakon Overli noted in mid-2013, “There is simply less money around as some funds are coming to the end of their investment periods, and fewer managers are closing fresh funds.”<sup>27</sup> The number of active VC firms in the United States has fallen from nearly 1,000 in 2000 to about 450 in 2007 and fewer than 300 in 2013.<sup>28</sup>

Governments, too, are broke, so in many places government funds to support startups are scarce and getting scarcer. Even the proverbial 3Fs—family, friends, and fools—have less money to invest in their loved ones’ startups, because they, too, have been broke or overleveraged since the global financial crisis came calling.

Last, according to Dealogic, just one in six initial public offerings (IPOs) in 2013 were technology companies, making it the tech industry’s second-worst showing in 20 years. In 1999, at the height of the 1990s technology boom, some 69 percent of IPOs were tech or Internet companies.<sup>29</sup> VCs are hoping that Twitter’s successful IPO in 2013 will lead to a turnaround. Time will tell.

So if you need cash for your next venture—whether within an established company or for a venture you are hatching in your garage—I suggest you spend your time on your customers and your business, rather than on raising capital. Once you get customer traction, more capital is likely to follow, if you want it and need it. As we’ll see in Chapters 3 through 7, many of our exemplar companies eventually raised significant institutional capital. But that’s the point. Counterintuitively, by waiting to raise capital until proof points had been achieved—the magic of customer traction—raising

**“many of our exemplar companies eventually raised significant institutional capital.”**

capital, and more of it, became dramatically easier. Will we soon see a revolution in which entrepreneurs dump their PowerPoint slides and look to their customers as their first ports of call? Will tomorrow's entrepreneurs—and leaders of growth-starved established companies, too—see customers as the most sure-footed basis for starting, financing, and growing their companies? Will business angels and incubators play the role I hope they will play in driving this change, and perhaps dramatically improve their returns in the process? We'll know very soon.

## Is Customer Funding the Right Approach for Every Venture?

Should every entrepreneur and executive jump onto the customer-funded bandwagon? No. Customer-funded models don't suit every business. If your idea is to build a dam with a hydroelectric power plant to meet today's voracious thirst for energy, for example, conventional project finance is a more sensible source of the funding you'll need. Users are probably unlikely to pay you for tomorrow's power today. But if one of the five customer-funded models suits your circumstances, perhaps it's a better way forward for you.

## When Customer Funding Goes Wrong

A customer-funded approach can offer your business numerous benefits, as will become abundantly clear as this book unfolds. But it's no panacea, it doesn't guarantee your profitability, and it won't replace getting the rest of the fundamentals right, either.<sup>30</sup> As longtime venture capitalist Bill Egan famously remarked, "You may have capital and a talented management team, but if you are fundamentally in a lousy business, you won't get the kind of results you would in a good business. All businesses aren't created

equal.”<sup>31</sup> Even customer-funded ones! So does customer funding sometimes go wrong?

Consider Groupon, the daily-deals high flyer that has experienced nothing but turmoil since its eagerly awaited IPO at

the tender age of three years in November 2011, when it raised \$700 million in what was the largest IPO by an American Internet company since Google’s in 2004.<sup>32</sup> Groupon, as almost everyone on Planet Earth knows, offers its members discounted “daily deals” at a plethora of local restaurants, day spas, helicopter tour operators—you name it. Its ingenious customer-funded model—which is both a scarcity model (the deals are only open for a very short time) and a pay-in-advance model (customers pay for the deal on the day it’s offered, then visit the restaurant or take the helicopter tour later, or perhaps never)—puts enormous amounts of cash into Groupon’s coffers, a portion of which it then (eventually!) pays out to its merchants in installments over an extended period, often as long as 60 days. Would you like to have this kind of float in your business?

This tsunami of cash, along with subsequent VC funding, enabled Groupon to make acquisitions of 17 mostly copycat companies in a little more than a year, expand into 45 countries, grow its merchant roster to 78,466, and grow its employee base from 37 to 9,625 in only two years.<sup>33</sup> “Can businesses having customer-funded models grow quickly,” you ask? You bet they can!

But is Groupon really a viable business? That’s a very different question. Groupon was forced

to restate its financials twice before its IPO, cutting its reported 2010 revenue by more than half, and again afterwards, increasing its quarterly loss for the fourth quarter of 2012 from \$42.3 million to \$64.9 million.<sup>34</sup> It seems that the company hadn’t set aside

**“You may have capital and a talented management team, but if you are fundamentally in a lousy business, you won’t get the kind of results you would in a good business.”**

**“But is Groupon really a viable business?”**

enough money to cover customer refunds, particularly for more expensive services like laser eye surgery, where refunds were running higher than expected.<sup>35</sup> Why is this a problem? Some customers will change their minds (“Maybe I don’t want LASIK surgery, after all.”), and some merchants will go bust, leaving Groupon holding the bag for unredeemed services. Thus, because Groupon cannot be sure how much money to set aside for future refunds, which it guarantees to its customers, its revenue figures after expected returns are iffy at best.

Okay, so what about the expenses that operating Groupon’s business entails? Groupon’s tsunami of cash makes it easy to *pay* the expenses, but covering them with enough gross margin dollars to actually book any *profit* is quite another story. Groupon has been unprofitable every quarter, before and since its IPO, in part due to its aggressive spending to grow its user base. The losses, the financial reporting issues, the fall in Groupon’s stock price to around \$4.00 (one-quarter of its IPO price), the fact that Groupon’s model is easily copied (thereby making its business ferociously competitive), and a decline in its international revenues all eventually took their toll, leading to the firing of founder and CEO Andrew Mason in February 2013.<sup>36</sup>

Groupon remains awash in cash, as I write in late 2013, but its stock price, despite its recovery from around \$4.00 to \$9.00,

**“Will Groupon be able to recover its mojo?”** remains at around half of its IPO price.<sup>37</sup> Will Groupon be able to recover its mojo, or change its strategy and business model to something that can generate profits as well as cash? It’s anybody’s guess. But the good news for Groupon is that its customer-funded model at least gives it a war chest with which to try.

The Groupon story is one example of how customer funding can go wrong, though it’s fair to say that having plenty of your customers’ cash—despite no profits—is a nice problem to have! Perhaps a more sinister downside of customer funding is when companies with lots of market power (e.g., large supermarket or

other retail chains) use that power to demand onerous terms from their sometimes much smaller and less powerful suppliers. Supermarkets get their customer's cash on the day the customer buys, or perhaps a day or so later when the customer's credit card payment clears. That's a wonderful source of customer funding to the supermarket, which hasn't yet paid its suppliers for what the customer just bought. But if the supermarket demands 60- or 90-day terms from its suppliers, as some do, that puts stress—as well as additional cost—on the ability of its suppliers to finance their own businesses, while they wait for—or find a way to finance—the supermarket's slow payment. It's not really a downside of the supermarket's customer funding, per se, as the problem lies on the supply side, not on the customer side. But it is the customer and supplier sides of the working capital equation, working together, that deliver the necessary cash to operate the business. Abusive behavior toward suppliers is not what this book advocates.

### The Vermas: The Rest of the Story<sup>38</sup>

At the outset of this first chapter, you read how Rakesh and Rashmi Verma built a growing services business that had grown by 2004 into what many regarded as India's premier source of navigable, accurate, detailed digital maps of all kinds. What next? On a visit to the United States that year, the Vermas observed that MapQuest had built a product wherein consumers or others could obtain exactly the maps they needed, anytime, anywhere, simply by going online. “Could we do a MapQuest for India?” they wondered, and MapmyIndia was born.

“**Could we do a  
MapQuest for India?**”

Not content with developing a new customized mapping solution for each of its customers, as the Vermas had done in the past, MapmyIndia would “productize” its mapping data, and let its customers and users—from retailers seeking to inform consumers

where stores were located, to consumers seeking location information of all kinds—do the work: zooming in for more detail, zooming out for the big picture, and more. A heretofore not very scalable services business would, if all went well, become a highly scalable product business.

Developing such a business would take capital, though, for algorithms, software development, GPS technology, and much more. No longer was it realistic for customers to fund the growth of the business. MapmyIndia's first small round of venture capital was raised from California-based investors Kleiner Perkins Caufield & Byers and Sherpalo Ventures in 2006, valuing the still-small company—whose revenue in the prior year was barely \$1 million—at about \$7 million.

Three further rounds of capital at higher valuations followed in 2007, 2008, and 2011, as MapmyIndia grew its product offering: consumer navigation devices for the auto aftermarket à la TomTom; fleet tracking solutions for the taxi and logistics industries in India; licensed content for automobile manufacturers' in-dash infotainment systems; locator content via the Web; and even a \$50 app to turn anyone's iPhone into a navigation device for India. And the original services business kept humming along, too. One might think of the company today as MapQuest and TomTom or Garmin, for India, rolled into one.

## What Angel Investors Will Want to Know—and Will Ask

I've argued that successful application of any of the customer-funded models is likely to make it possible, even relatively easy, for an aspiring entrepreneur to raise capital later from business angels or institutional VC investors. The case histories in Chapters 3 through 7 will bear me out. But that doesn't mean these investors won't ask any tough questions! Indeed, experienced investors in early-stage companies know the risks are acute, and that many if not most of their investments will not pan out.

Hence, three critical issues are always at the top of their minds as they contemplate investing in a young company:

- Does the product or technology actually work?
- Is there sufficient customer traction to indicate that market demand is genuine?
- Is the business model sufficiently capital efficient that significant further progress can be made without my writing more checks? While most venture capital investors expect to “follow their money” with additional rounds of capital as needed, most angels have learned—the hard way—that writing additional checks often amounts to throwing good money after bad.

**“most angels have learned—the hard way—that writing additional checks often amounts to throwing good money after bad.”**

Let’s consider an early-stage business that’s off to a good start using any of the five customer-funded models, and subsequently seeks funding to ramp up its growth rate or serve new target markets. Does the technology work, and is there customer traction? It does and there is! If the business is ready to ramp up, that means both of these things are already true. Is the business capital efficient? If the business has been getting along on customer funding, this suggests that additional capital can be used to support faster growth, rather than the everyday basics, which the customer funding already covers.

But these three questions, crucial as they are, represent only the tip of the iceberg for the questions an experienced business angel will (or should!) ask. For each of the five models, there are additional, more model-specific questions that will or should arise, like these:

- What are the settings in which each of the five models is best applied? To services businesses or products? For consumables

or durables? To business-to-business, business-to-consumer, or consumer-to-consumer marketing strategies?

- What are the “how-to” lessons to heed in putting each model to work? Experienced investors know that while planning is important, effective implementation is what actually delivers the results.
- What common pitfalls must the entrepreneur and his or her backer watch out for?

Thus, at the end of each of Chapters 3 through 7, I’ll draw on the body of research that underlies this book to highlight the key lessons that pertain to each of the five customer-funded models. These end-of-chapter sections—and the “John’s Business Angel Checklists” that summarize them—are intended to do four things for business angels, entrepreneurs, and leaders in established companies who see the potential of customer funding in growing their businesses:

- Equip you, my readers, with the tools and insights you will need to figure out which of the five models might work in *your* business or one you are considering backing.
- Draw on the experience of others who’ve already been down the track with each model, both entrepreneurs and their backers, to head off some of the likely mistakes *before* you make them.
- Provide business angels, other early-stage investors, and even corporate investors with a set of due diligence questions they can ask when contemplating an investment in a customer-funded business—or one that could be! My hope is that angels will nudge aspiring entrepreneurs with promising ideas into thinking about pursuing their dreams via one of the five customer-funded models, rather than seeking capital before anything is really proven. “Here are some ideas about how better to fund the launch of your

business,” such an angel might say. “Come back and see me when you’ve put them to work and customer traction is evident, and I’ll then help you ramp up.”

- Assist business angels in contributing to the effective management of their customer-funded investee companies. The most important things investors bring to their investees aren’t their dollars, euros, pounds, or rupees. The really important things are the sage counsel they bring when crucial decisions are faced. This book’s lessons, based on the journeys of other entrepreneurs who have applied these models and the investors who backed them, can add useful perspective in facing such decisions.

**“The most important things investors bring to their investees aren’t their dollars, euros, pounds, or rupees.”**

Though these lessons have been gleaned largely from entrepreneurial journeys, rather than those of a more corporate kind, there’s a good reason why. Out of necessity, entrepreneurs, more than their corporate brethren, have been forced by their lack of resources to find customer-funded paths. As we saw in the Ryzex story earlier in this chapter, though, the lessons apply equally to established business settings.

## The Road Ahead

In Chapter 1, I’ve provided a brief overview of what the five customer-funded models are all about, why they might be relevant to your business or one in which you may at some point invest, and what you’re in for in reading the rest of the book. Other than the story of the Vermas’ journey from a small IT training company to becoming the dominant digital mapping company in India, however, I’ve not yet brought any of them to life in any depth. In Chapter 2, I’ll address two important

questions about customer-funded models: “Are these models a mirage or a mind-set?” and “Is there anything really new here?” At the end of the chapter, I’ll begin posing some of the questions that angel investors will (and should!) ask, as illustrated in the case histories of the early origins of Banana Republic and Dell. These questions should help you begin thinking about whether taking a customer-funded approach might actually work to build what could turn out to be a customer-funded business for *you*.

In Chapters 3 through 7, the heart of the book, I’ll bring each of the five customer-funded models to life through the case histories of more than a dozen incredibly innovative—and often inspiring—twenty-first-century entrepreneurs who have created and applied them in building their fast-growing companies. Not all of them, however, have been successful!

Then, to close the book in Chapter 8, I’ll recap and bring together the key lessons—for entrepreneurs and business angels, too—that transcend the five models. I’ll also pull together a number of crucial lessons about implementing each model, so you’re ready to hit the ground running as you start to apply one or

**“So, are you ready to be inspired? To take your entrepreneurial game to a new level?”**

more of them. So, are you ready to be inspired? To take your entrepreneurial game to a new level? To improve your angel investment returns? To embark

on a customer-funded—and customer focused—journey in *your* business or one you may back? Turn the page and read on!

## About the Research

The research journey of which this book is a part began during my sabbatical in 2000 at London Business School. There, freed to think and study for several months, I sought to identify what I hoped would be a better and more disciplined way to assess entrepreneurial opportunities, in an effort to nudge the needle downward on the entrepreneurial failure rate. Fortunately, that research bore fruit in my “seven domains” framework, developed in *The New Business Road Test*, first published in 2003, with new updated editions published in 2006, 2010, and 2013.

In time, my work applying the seven domains framework with hundreds of entrepreneurs led me to dig deeper into business models, especially those that spurred real breakthroughs in their industries—like Southwest and Ryanair in airlines and Zara in apparel retailing. Once again, a book, *Getting to Plan B*, co-authored with Randy Komisar, was the happy result.

In researching the companies whose stories are told in *Getting to Plan B*, and in my ongoing work with growth-minded entrepreneurs and other business leaders who instinctively understand that cash flow—not profit—lies at the heart of most business breakthroughs, I became further intrigued with companies profiled therein like Dow Jones and Costco, whose working capital models lay at the heart of their continued success. “How might even better working capital models be constructed?” I wondered. “And, if they’re constructed well enough, might they enable entrepreneurs to fund their businesses with their customers’ cash, at least at the outset, if not forever, rather than having to take time away from their customers to raise the capital required?”

As this latest phase of my research journey got underway in early 2012, my research partner and former student (and an inspiring entrepreneur in her own right), Nell Derick-Debevoise and I began searching for companies who appeared to get their starts with customer funds. We then examined their approaches to learn whether and how they had done so, eventually synthesizing the five types of customer-funded models articulated here. Of the more than 40 candidates we found at the outset, we culled the list to the nearly 20 whose captivating stories are told here.

Concurrently, I began interviewing entrepreneurs and investors—both VCs and business angels—with an eye toward better understanding what matters in the effective implementation of customer-funded models. Planning is important, I learned long ago, but implementation is what really matters in delivering results. “What,” I wondered, “were the best settings in which to apply each of the five models? How might they best be implemented? What are the common pitfalls that lurk along the path? And what are the key questions about each of the five models that business angels or other investors should ask?”

The results of my and Nell’s research are what you now hold in your hands or see on your screen: the often inspiring stories of some of the world’s most inventive and ambitious entrepreneurs and the companies they’ve built, whether successfully or—in several noteworthy cases—not. The stories, organized around the five different customer-funded models we’ve identified, are perhaps the most engaging part of the book, as they bring to life lessons not only about customer funding but more generally about life as an entrepreneur. I believe people in all kinds of companies—nascent or long established, large or small—and investors, too, can learn important lessons about how to start, finance, or grow their companies from their entrepreneurial brethren and their stories, as recounted here. Perhaps the most concisely instructive parts of the book, though—for entrepreneurs, other business leaders, and investors alike—are the checklists at the end of the five customer-funded model Chapters (3 to

7), and in the book's second (2) and final Chapter (8), which summarize and impart the key lessons our research journey has uncovered.

As this book is the product of what is called in the academic world “inductive research,” based on a very modest sample of entrepreneurs and their companies, I won't argue that the lessons presented here are the only ones to be gleaned, nor that 100 percent of them will stand the test of time forever in our fast-changing world. Any errors in the insights I've drawn are mine and mine alone. And I won't even argue that those insights are necessarily “correct,” as the entrepreneurial world is full of courageous and thoughtful people who break the rules. You, the reader, may find that some of the rules herein are made to be broken, too.

But it's my hope that the lessons I've learned and recounted in this book will encourage tomorrow's entrepreneurs, investors, and executives to focus their efforts—first and foremost—on solving their customers' problems and unmet needs, rather than on raising money from investors, at least at the outset. As you'll have seen in many of the compelling stories in this book, get it right with your customers, and the investors—if you need them at all!—will in all likelihood follow.

## About the Author

When he's not out in the world learning from or working with entrepreneurs and those who invest in them, John Mullins divides his time between London, the most captivating and livable big city in the world, and the much smaller and more intimate town of Golden, Colorado, nestled at the edge of the foothills of the Rocky Mountains. A former entrepreneur and now an award-winning professor at London Business School, John is the author of two best-selling books, as well as dozens of case studies of real-world entrepreneurial companies, plus more than 40 other publications.

Now in its fourth edition, John's first book, *The New Business Road Test: What Entrepreneurs and Executives Should Do Before Launching a Lean Start-up*, has become the definitive work on assessing entrepreneurial opportunities. His second book, with noted venture capital investor Randy Komisar, the critically acclaimed *Getting to Plan B: Breaking Through to a Better Business Model*, provides a field-tested process and framework for helping entrepreneurs get from their initial "Plan A," which often doesn't work, to a more economically viable "Plan B."

John is a sought-after speaker to audiences around the world on entrepreneurship, on growing one's business, and on starting and financing high-potential ventures. He can be reached at [jmullins@london.edu](mailto:jmullins@london.edu).

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# WHAT INVESTORS ARE SAYING ABOUT *THE CUSTOMER-FUNDED BUSINESS*



"*The Customer-Funded Business* should be mandatory reading for every entrepreneur before even thinking about seeking angel or venture capital funding. It's also the perfect 'what to look for' guide for the professional angel investor. I will be giving a copy to every startup that pitches me!"  
—**DAVID ROSE**, Founder of *New York Angels*, CEO of *Gust*; Author of *Angel Investing*

"As a venture capitalist, nothing is more valuable to me than getting first-hand market feedback from customers about their experience with a new "killer" product. *The Customer-Funded Business* expertly argues that the best and usually shortest path to developing that killer product is by getting customers to pay for it. By following the precepts of John's book, and financing a business primarily from customers willing to be early adopters, entrepreneurs will have a much clearer and more persuasive blueprint about how to build the business, and therefore have a far easier time raising venture capital (and incur less dilution, too)."  
—**BRUCE GOLDEN**, General Partner, *Accel Partners*; *Forbes* Midas List of Top 100 Venture Investors

"I get sent, and buy, a large number of business books every year. *The Customer-Funded Business* is simply one of the best, most informed books I have read in a long time. Fascinating case histories of customer-funded companies all over the globe. A must-read if you are considering starting your own business, or funding a new initiative."  
—**DAVID GIAMPAOLO**, Chief Executive, *PI Capital*, London

"A book I'd like to give to each of the founders we've backed. In this fascinating study of successful—and not so successful—customer-funded businesses, John Mullins distills the lessons learned into simple rules. A valuable and entertaining read for anyone seeking to build a capital efficient business."  
—**MICHAEL ELIAS**, Founder and Managing Director, *Kennet Partners*

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