8 ways to validate a business idea, including detailed explanations

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Author: Dr. Mihails Kuznecovs

According to Eurostat, around 2.6 million businesses open every year aiming for prosperity and financial gain, yet more than 50% of these are expected to close down in their first five years.[x] The business arena is a fierce territory, where only the best succeed and the majority is expected to break even and/or go bankrupt. Nevertheless, to establish a business, to develop something great with added value that becomes recognised, and to see how this has positive socio-economic effects is a welcome pleasure for business founders.

8 WAYS TO VALIDATE A BUSINESS IDEA

According to Eurostat, around 2.6 million businesses open every year aiming for prosperity and financial gain, yet more than 50% of these are expected to close down in their first five years. Below is a list of 8 proposed ways that a business idea can be validated (or an existing business can be strengthened).

1. Know your market niche and competitors
2. Fully understand your income potential
3. €$¥£₽ Understand every cost of doing business
4. €$¥£₽ Working capital should not be underestimated
5. ?? ?? ?? What general and specific business limitations may be encountered
6. What are the legal aspects and permissions, if required
7. What human resources and outsourcing are required
8. What is Plan B and exit strategy

There are so many great academic books, articles and interviews with successful entrepreneurs that if someone decides to follow all the advice, it seems that they should become successful; however, it happens in rare cases only. Mainly, this is because aspiring entrepreneurs are entering dynamic world of business with so many (potentially avoidable) obstacles and unexpected situations (where they could find themselves in the wrong place at the wrong time). The insight below focuses on the things that business owners or managers should be aware of and expect to deal with.

[x] Business demography statistics, Eurostat https://ec.europa.eu/eurostat/statistics-explained/index.php/Business_demography_statistics#General_overview (Accessed on 30th April 2019)

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1. Know your market niche and competitors

This validation question pertains to market survival considerations and, to some extent, is the very first question any entrepreneur or business manager should ask:

1.1. How unique is the idea—is this a new business, or improvement upon something that already exists; is this easy to replicate, etc.?
1.2. What is the lifespan of the business—is this seasonal, all year round, or it is a long-term business for the next 5, 10 or even 20 years?
1.3. Geographic coverage—is this a local business for a specific area (district, city, region, country), or maybe it has an international potential?
1.4. How transferable/adaptable is this business idea to other industries and markets—can the business expand to other markets and regions and how this can be achieved?
1.5. How will the business remain competitive—do you plan to do trademarks, patents, significant market penetration or exclusive long-term contracts, best location, etc.?

2. Fully understand your income potential

The aim of this question is to define a realistic income generation level, based on market potential, and to foresee what long-term sustainable income level can be achieved:

2.1. What is the income (or sales) capacity—how much, at maximum, can the business generate services (or products)?
2.2. What is realistic income level that can be achieved—for example, 50%, 60% or maybe even 90%?
2.3. What is the market penetration level in the first year, in the third and fifth years—that is, how long will it take to achieve an adequate competitive and financially sound income level?
2.4. What are any income restriction factors—anything that can affect a sales decline from too-high inflation, competitors and alternative services?

3. Understand every cost of doing business

By answering this question, business owners and managers will be able to identify relevant expenses that accrue during the development stage, capital investment estimations during actual business operations and significant long-term updates. This way, by knowing the cost structure and its likely levels and timing, the business can be managed effectively:

3.1. Do you know all start-up/development cost prior your business becoming operational?
3.2. Do you know your capital cost and its future maintenance cost over the years?
3.3. Do you understand every cost that will exist once you become operational?
3.4. Do you fully understand financing and its terms and conditions?
3.5. Have you invested adequate resources in financial consultations and business case preparation during start-up, and have you allocated professional consultancy costs once in operation?
3.6. Have you considered the cost to upgrade or re-invest into the business after its initial lifespan (for example, to buy new equipment)?

4. Working capital should not be underestimated

Working capital is one of the key business considerations that is often overlooked, and as a result it may have a significant, adverse effect on the company's operational ability, i.e., there will not be enough funds available to operate the business on a daily basis. It is highly advised to approach working capital and respective safety cushion allocation with a pessimistic view—that is, that income receivable will be delayed, but expenses need to be paid in the following days. This approach should allow for allocating enough working capital toward interrupted and smooth business day-to-day operations and avoid short-term cash flow disturbances:

4.1. What is the initial safety cushion required—for example, how much money does your business require to survive without any income in the first 6, 12 or 24 months?
4.2. What is the standard level of working capital—i.e., what is the difference between incoming and outgoing funds needed in order for a business to avoid cash flow shortage (for example, do you require 10 days or 30 days or maybe 90 days for income to be received, but you have to pay for inquired cost in the next 15 days)?
4.3. Have you considered adequate working capital insurance—have you covered for unexpected income generation loss or unplanned costs, which can unbalance your standard cash flow?

5. What general and specific business operational limitations may be encountered

Regardless of business size, industry, geographic location, your business can face problems. This could be anything from a sudden key employee decision to leave the company to a simple and yet unwelcome temporary website crash. Hence, it is worth being prepared for potential business obstacles and limitations that might happen. It is recommended that a company establishes respective risk management and crisis management trainings.

6. What are the legal aspects and permissions, if required

Legal considerations should not be avoided, as these aim to protect businesses in cases where something goes wrong, from delayed invoice payouts to third-party liability protection. Similarly, special attention should be dedicated to understanding the need for permissions, licenses and any other approvals that might be required to operate the business:

6.1. Have you had legal consultation toward business opening and operations—this should help to set your business structure, prepare necessary legal documentation in advance both for business registration and once in operation.

6.2. Have you thought of the required permissions to become operational—failure to do so may have severe effects on your business potential including enforced closure.

7. What human resources and outsourcing are required

Employees, even when outsourced, are the key for business efficiency, as they are the ones who execute company activity and are on the frontline when it comes to customer satisfaction and long-lasting relationships. Therefore, human resources need to be treated well—from comfortable office space with respective health and safety, up to motivational encouragement, continuous training and financial benefits:

7.1. What general and specific human resources does your business require—can you find and continuously invest in respective training?

7.2. What is your strategy in order to retain your employees in the longer term and to maintain their productivity?

8. What is Plan B and exit strategy

Businesses cannot be fixed, but must continuously adapt to their surrounding environments. This should not mean chaotic organisational changes or revisions to how to operate and generate income. There has to be a logical, well-thought-out strategy (including a Plan B), that answers questions “what if” and “how.” This business strategy has to continuously be revised. At the same time, the business has to have an exit strategy and to allocate enough resources for this decision:

8.1. If your main business plan fails for any reason, what is your Plan B—can you promptly adapt your services (or product) to another market niche and/or region, and do you have extra funds for this?
8.2. If there is no alternative business solution (Plan B), have you prepared for business closure—do you have adequate resources to cover the cost of business termination?

To summarise, we have prepared above a list of eight ways that a business idea (or existing business) can be validated. This list consists of key considerations from market understanding, income level setting, associated cost planning, and all the way up to exit strategy, which are not the only considerations by any means (additional and more detailed considerations may be added from academic resources or through the experience of other entrepreneurs, as it all depends on the specific business conditions) and yet the fundamental principles remain the same: thorough analysis and avoiding overly optimistic expectations are vital for any business to succeed in the longer term.

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