Start-Up Challenges: Initial Customers & Suppliers – Getting It Right First Time

This is the third part of our new blog focussing on issues faced by young companies. White Lake's team are experts in the identification of these issues, origination of solutions and execution to ensure your business does not fall into any of the pitfalls reported in our Series B investment blog.

Doing Business: Relationships with Customers and Suppliers

As companies get ready to go for Series B – they need to have enough commercial traction to attract interest – as a product company this means at a minimum >£1,000,000 in sales. From a standing start this is a daunting target – hence it is important to get the initial market approach correct for the revenue target you have before looking for additional financing.

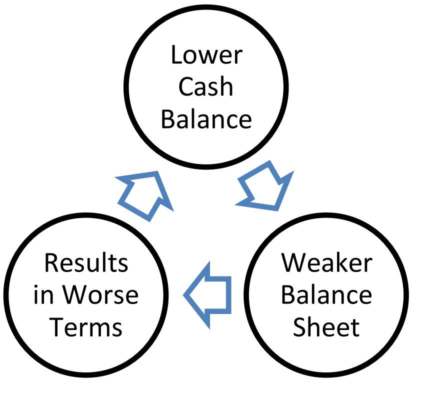
Initial Customers:

As companies grow – relationships with initial customers can have a huge bearing on how a company develops. We have seen companies who have gotten the terms of their initial sales wrong struggle for the following 12 months to undo the damage. i.e. a first sale at an uncommercial price way below the actual value proposition signals to the market a pricing which is then hard to alter. Their eagerness to make a first significant sale proved to be to their detriment. An alternative to this is to be slightly more open book with initial customers (obviously we are talking B2B here). If you have a novel product/service that is valuable to them – you have more weapons in your arsenal than just pricing power. Exclusivity is the obvious one – again the terms of this are important – typically exclusivity needs to be maintained by a minimum order quantity to make it worth giving. Geographical segmentation, industry vertical segmentation and preferred pricing may be valuable tools when working on exclusive arrangements.

Another route young companies often take is to offer initial "test" products for free – especially in the industrial/cleantech space. You offer your products for test and then hope for a follow-on sale following a successful demonstration. Our view is that it is always best negotiate a framework agreement upfront which is along the lines that a follow-on sale is guaranteed should the product meet easily measured criteria. If a customer will sign a framework – it proves intent. No one will refuse a free product to test with no strings attached so what have you proven?

Initial Suppliers

On the supply side – suppliers have certain terms for companies with a strong balance sheet and certain terms for companies who don't. We have seen procurement teams quoted initial prices and terms only for these to change drastically when said supplier dug into the financial strength of their customer on an actual order. This has totally thrown the gross margin of the company and thus a vicious circle starts:



How to fix the above?

One of the best ways to fix the above conundrum is also one of the hardest to arrange and takes very strong relationship building with initial customers and suppliers. Essentially you look to use the credit rating of your main customer (assuming they are blue-chip) and use this alongside a PO to get favourable terms from the supplier. You "back to back" your suppliers order against your customer. For off the shelf supplies this can work more easily. The risk for the supplier is that your company cannot build the finished good to the correct standard using raw materials supplied by them and thus you never make it to invoice. However once you have a customer that has taken initial product – which is working successfully, this arrangement can work. Another issue with the "back to back arrangement" is that many large blue-chip customers (ex. utilities) already have such unfavourable terms for their suppliers (you!) it is impossible negotiate with them. One of my pet peeves is large firms pushing financing requirements onto their weaker suppliers even though they have the lowest cost of capital! These large corporates think they are doing themselves a favour whereas they are just upping their costs as their suppliers have to finance this somehow – and it is normally translates into higher prices.

Below are a few more areas we are dealing with in summary this week.

	Angel backed company problems	Solution
1	Operations: No ability to negotiate with larger customers (in particular, those that know they are the only initial customer)	Make your customer a "Partner" in return for exclusivity and thus get better terms on working capital – prepayments/pricing etc. Set up 2-3 customers to compete off each other for exclusivity. Make initial product sales as part of an MOU with guaranteed follow-on sales if certain conditions are met as opposed to giving test product.
2	Operations: Terms with suppliers: Negative gross margin as they have not the purchasing power to drive costs out of the value chain	Potentially use a major customer as an underwriter on goods from suppliers – use their credit rating as a pass through.
3	Business model: Not enough commercial traction by the time they go for Series B and not enough Angel backing to keep going at that point or to change strategy belatedly	Design a business ramp-up which goes to cash flow positive at the smallest possible revenue which then takes the pressure off a large series B and allows organic growth in the meantime.
4	Business model: Picking the wrong go to market strategy/partners and only having one shot at it.	Hire strategy consultants early on. Use VC feedback even at an early stage to vet business model being employed.
5	Operations: Team has been in start-up mode and have not got the businesses processes in place to handle even moderate growth.	Get each manager to map basic business processes and responsibilities for each of the team. Running a suitable S&OP (Sales & Operation Process) well may be the most important in the business.
6	Operations: Weak board reports – thus weak management measurement criteria	Design a Board pack which is KPI dashboard led and relates directly to the org chart and budgets/dashboards of individual mangers. Traffic light dashboard is often best.
7	Finance: Working capital financing – extensive working capital needed for ramp up	Consider pre-payments and deposits from stronger customers in return for exclusivity.

White Lake is a company of VC Investment Managers who work with growth companies on strategic finance.

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