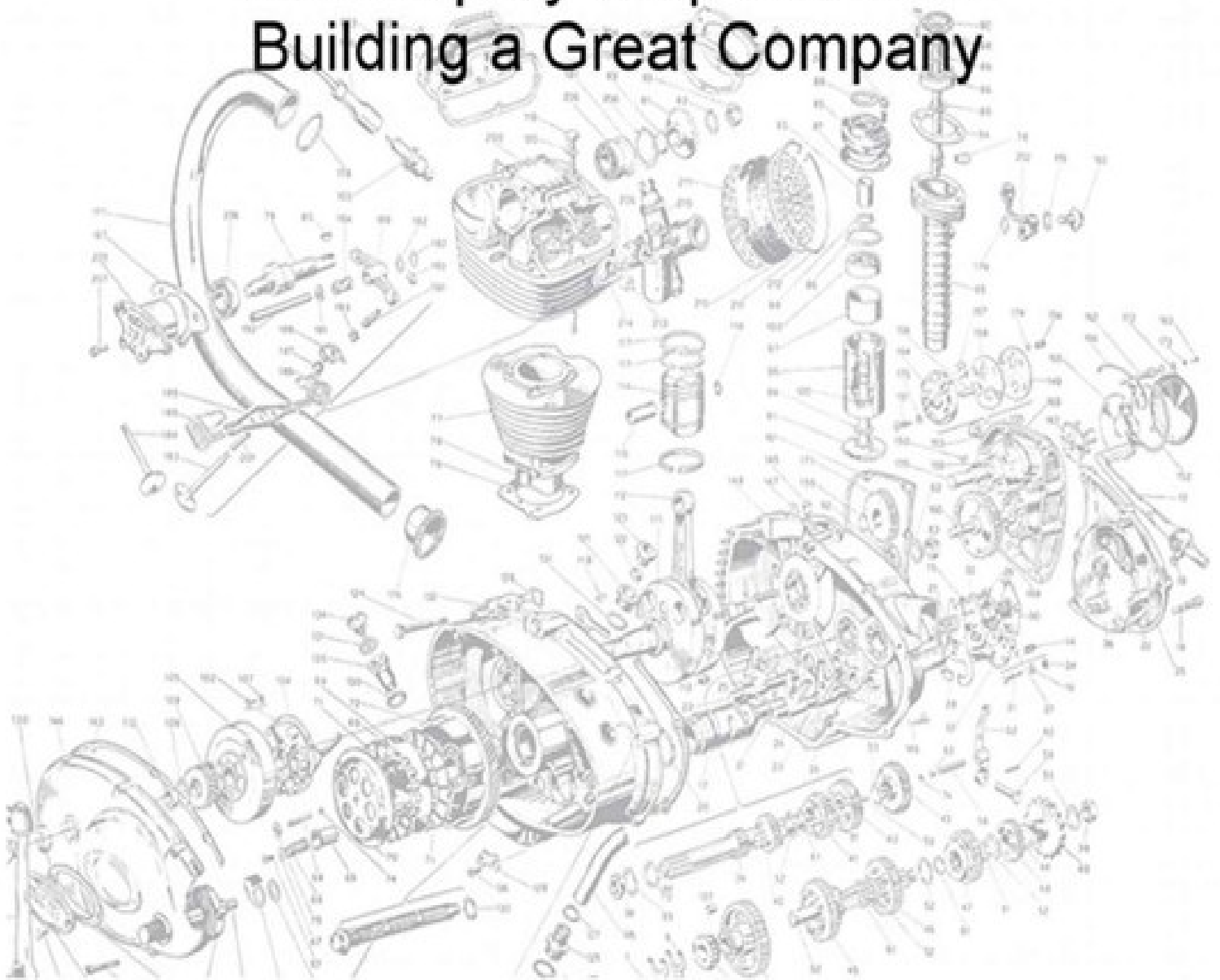


THE STARTUP OWNER'S MANUAL

The Step-by-Step Guide for
Building a Great Company

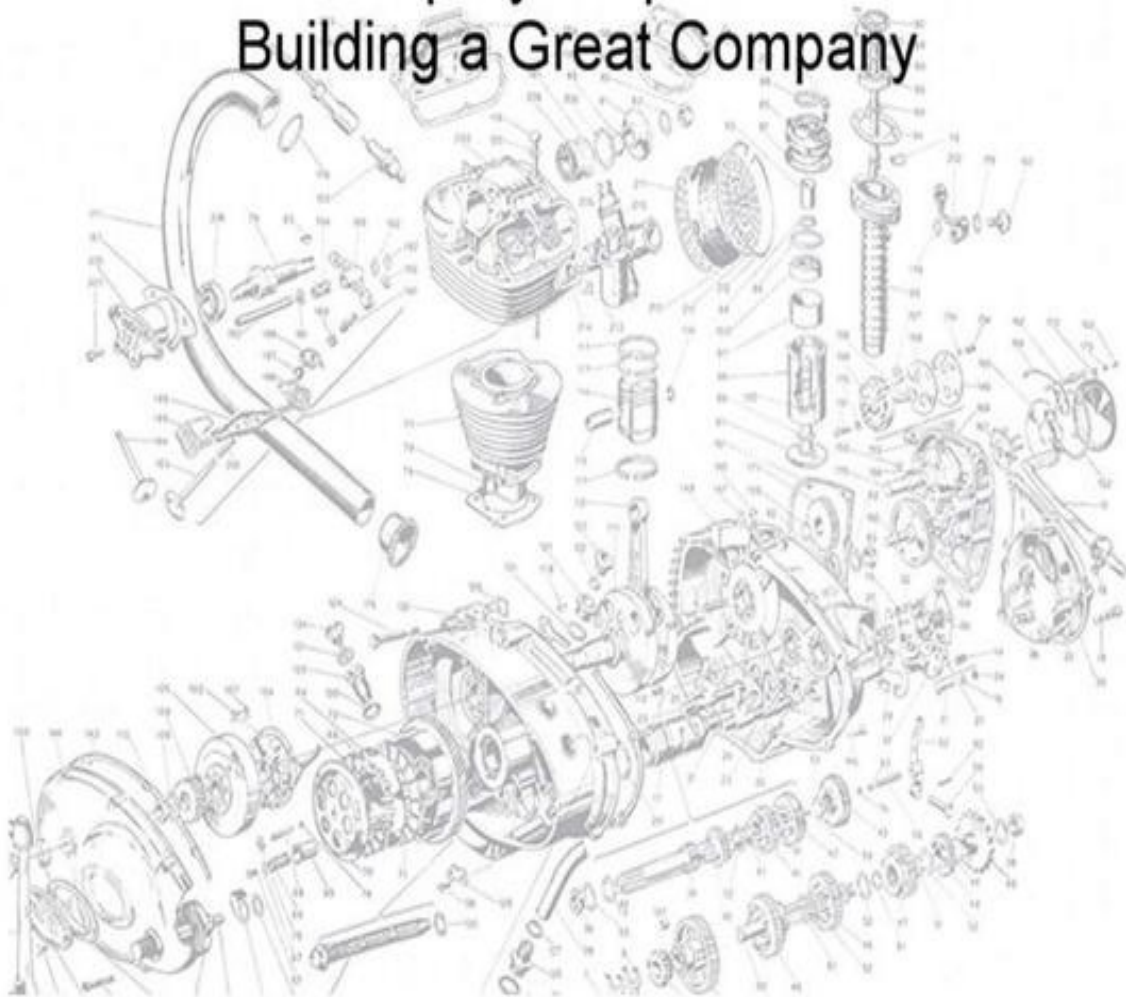


Steve Blank and Bob Dorf

“Get Out of the Building!”

THE STARTUP OWNER'S MANUAL

The Step-by-Step Guide for
Building a Great Company



Steve Blank and Bob Dorf

*The Startup Owner's Manual*TM
The Step-by-Step Guide for Building a Great Company
by Steve Blank and Bob Dorf

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About this Book

Welcome to The Startup Owner's Manual e-book.

Here you'll find all the tips, techniques and best practices that entrepreneurs need in their quest to build successful companies — packaged to suit your startup team's particular path. This e-book organizes The Startup Owner's Manual into three e-books to better help you navigate the text. In short:

- **Book 1: The Strategy Guide** provides background on, and an overview of the Business Model and Customer Development processes
- **Book 2: The Web/Mobile** e-book provides all the step-by-step process detail you'll need to create a solid, sustainable startup doing business in the web/mobile channel, and
- **Book 3: The Physical Channel** e-book offers the same for startups using physical channels

For best results, start your reading with the Strategy Guide.

The Startup Owner's Manual Strategy Guide makes up the first third of the e-book. It provides an overview of why startups are not smaller versions of large companies; explains how startups search for a business model using Customer Development; and details the overall customer development methodology, and key implementation steps.

For companies with virtual distribution channels, **The Startup Owner's Manual for Web/Mobile Channel Startups**, the second part of the e-book, provides a similar detailed, step-by-step process and approach for startups that sell via the web or app stores channels, where things move faster, customers are abundant, and customer attention is always hard to get.

If you're building a startup with physical distribution channels, you'll want to turn to the third part of this e-book, **The Startup Owner's Manual for Physical Channel Startups**. This section provides detailed guidance, instructions, and examples on how to build a great company, step-by-step. Included are details on how to get, keep and grow your customer base; checklists for tracking progress; and tools to help determine just how successful—or not—you can be.

We believe the Startup Owner's Manual can help you increase your odds of

finding customers, a market, and product/market fit. Now, as we say, “get of the building!” And best of luck with your startup.

Steve and Bob

Table of Contents

The Startup Owner's Manual Strategy Guide

Title Page

The Startup Owner's Manual Strategy Guide Table of Contents

Preface

Who Is This Book For?

Introduction

A Repeatable Path

Why a Second Decade?

The Four Steps: A New Path

Chapter 1:

The Path to Disaster: A Startup Is Not a Small Version of a Big Company

Chapter 2:

The Path to the Epiphany: The Customer Development Model

Chapter 3:

The Customer Development Manifesto.

Chapter 4:

An Introduction to Customer Discovery

Chapter 5:

Introduction to Customer Validation

Chapter 6:

Customer Validation: The Toughest Question of All: *Pivot or Proceed?*

The Startup Owner's Manual Strategy Guide Index

The Startup Owner's Manual for Web/Mobile Channel Startups

Title Page

The Startup Owner's Manual for Web/Mobile Channel Startups Table of
Contents

How to Read This Book

Getting Started

Chapter 1:

The Customer Development Manifesto

STEP ONE: Customer Discovery

Chapter 2:

An Introduction to Customer Discovery

Chapter 3:

Customer Discovery, Phase One:
State Your Business Model Hypotheses

Chapter 4:

Customer Discovery, Phase Two:
“Get Out of the Building” to Test the Problem: “Do People Care?”

Chapter 5:

Customer Discovery, Phase Three:
“Get Out of the Building” and Test the Product Solution

Chapter 6:

Customer Discovery, Phase Four:
Verify the Business Model and Pivot or Proceed

STEP TWO: Customer Validation

Chapter 7:

Introduction to Customer Validation

Chapter 8:

Customer Validation, Phase One:
“Get Ready to Sell”

Chapter 9:

Customer Validation, Phase Two:
“Get Out of the Building and Sell!”

Chapter 10:

Customer Validation, Phase Three:
Develop Product and Company Positioning

Chapter 11:

Customer Validation, Phase Four:
The Toughest Question of All: *Pivot or Proceed?*

[How to Build a Web Startup: A Simple Overview](#)

[The Startup Owner's Manual for Web/Mobile Channel Startups Index](#)

The Startup Owner's Manual for Physical Channel Startups

[Title Page](#)

[The Startup Owner's Manual for Physical Channel Startups Table of Contents](#)

[How to Read This Book](#)

[Getting Started](#)

Chapter 1:

[The Customer Development Manifesto](#)

[STEP ONE: Customer Discovery](#)

Chapter 2:

[An Introduction to Customer Discovery](#)

Chapter 3:

[Customer Discovery, Phase One:
State Your Business Model Hypotheses](#)

Chapter 4:

[Customer Discovery, Phase Two:
“Get Out of the Building” to Test the Problem: “Do People Care?”](#)

Chapter 5:

[Customer Discovery, Phase Three:
“Get Out of the Building” and Test the Product Solution](#)

Chapter 6:

[Customer Discovery, Phase Four:
Verify the Business Model and Pivot or Proceed](#)

[STEP TWO: Customer Validation](#)

Chapter 7:

[Introduction to Customer Validation](#)

Chapter 8:

[Customer Validation, Phase One:
“Get Ready to Sell”](#)

Chapter 9:

Customer Validation, Phase Two:
“Get Out of the Building and Sell!”

Chapter 10:

Customer Validation, Phase Three:
Develop Product and Company Positioning

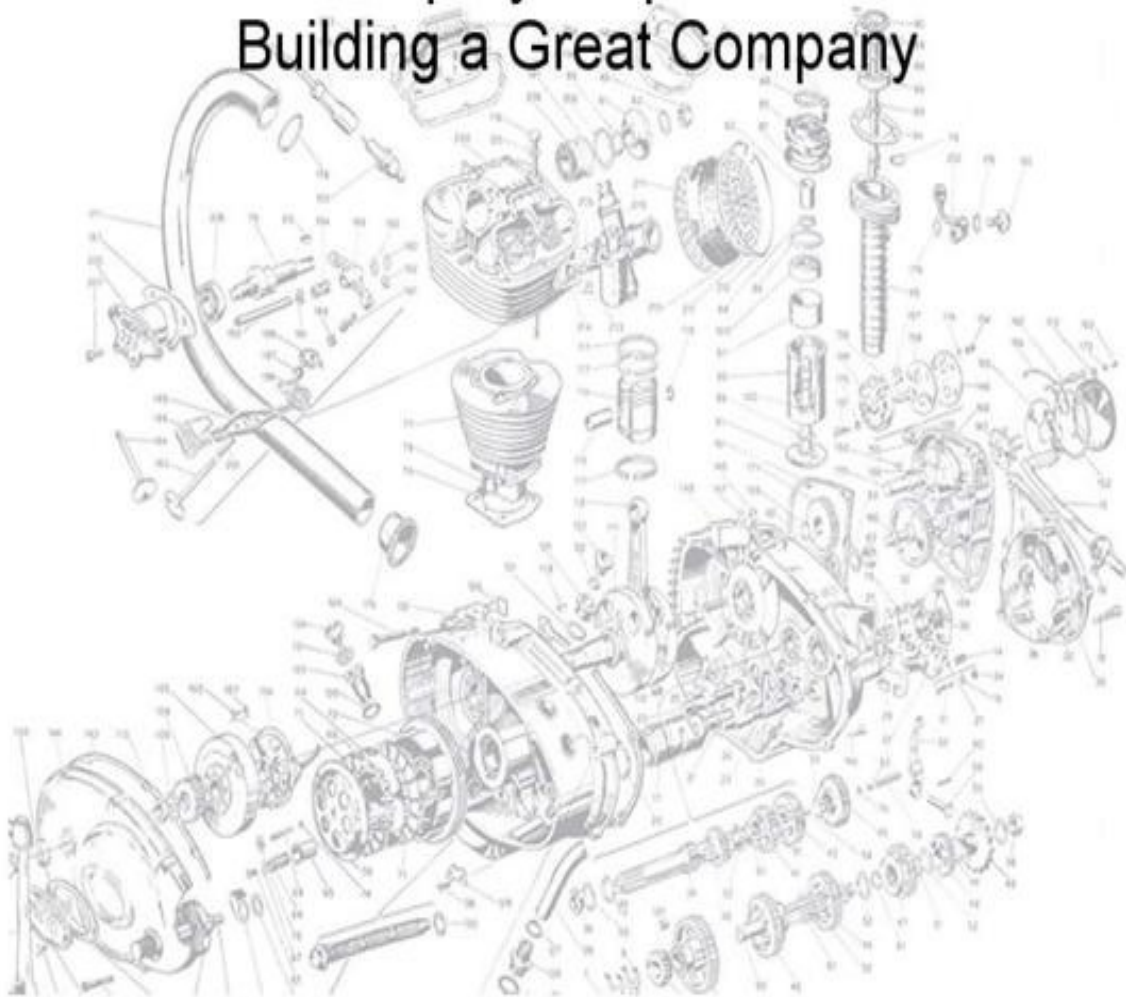
Chapter 11:

Customer Validation, Phase Four:
The Toughest Question of All: *Pivot or Proceed?*

The Startup Owner’s Manual for Physical Channel Startups Index

THE STARTUP OWNER'S MANUAL STRATEGY GUIDE

The Step-by-Step Guide for
Building a Great Company



Steve Blank and Bob Dorf

The Startup Owner's Manual

Strategy Guide

Table of Contents

[Preface](#)

[Who Is This Book For?](#)

[Introduction](#)

[A Repeatable Path](#)

[Why a Second Decade?](#)

[The Four Steps: A New Path](#)

[Chapter 1:](#)

[The Path to Disaster: A Startup Is Not a Small Version of a Big Company](#)

[Chapter 2:](#)

[The Path to the Epiphany: The Customer Development Model](#)

[Chapter 3:](#)

[The Customer Development Manifesto.](#)

[Chapter 4:](#)

[An Introduction to Customer Discovery](#)

[Chapter 5:](#)

[Introduction to Customer Validation](#)

[Chapter 6:](#)

[Customer Validation: The Toughest Question of All: *Pivot or Proceed?*](#)

[The Startup Owner's Manual Strategy Guide Index](#)

Preface

IN 1602, THE DUTCH EAST INDIA COMPANY, generally regarded as the first “modern company,” issued the first stock certificates. In the intervening 300 years, companies managed to start, build and grow without formally trained executives. By the 20th century, the complexity of modern corporations demanded a cadre of executives trained to administer large companies. In 1908, Harvard awarded the first master of business administration (MBA) degree to fill the need to bring professional education standards to big business. The MBA curriculum standardized and codified the essential elements an operating executive in a modern company needed to know: cost accounting, strategy, finance, product management, engineering, personnel management and operations.

Formal management tools are about 100 years old.

Fast-forward to the mid-20th century. The pairing of venture capital and startup entrepreneurship emerged in its modern form, and the startup industry they fostered has been exploding ever since. Yet for the past 50 years, finding the successful formula for repeatable startup success has remained a black art. Founders have continually struggled with and adapted the “big business” tools, rules and processes taught in business schools and suggested by their investors. Investors have been shocked when startups failed to execute “the plan,” never admitting to the entrepreneurs that *no startup executes to its business plan*. Today, after half a century of practice, we know unequivocally that the traditional MBA curriculum for running large companies like IBM, GM and Boeing *does not* work in startups. In fact, it’s toxic.

With the benefit of hindsight, entrepreneurs now understand the problem, namely that [*startups are not simply smaller versions of large companies*](#). Companies execute business models where customers, their problems, and necessary product features are all “knowns.” In sharp contrast, startups operate in “search” mode, seeking a repeatable and profitable business model. The search for a business model requires dramatically different rules, roadmaps, skill sets, and tools in order to minimize risk and optimize chances for success.

By the beginning of the 21st century, entrepreneurs, led by web and

mobile startups, began to seek and develop their own management tools. Now, a decade later, a radically different set of startup tools has emerged, distinct from those used in large companies but as comprehensive as the traditional “MBA Handbook.” The result is the emerging “science of entrepreneurial management.” My first book, [The Four Steps to the Epiphany](#), was one of its first texts. It recognized that the classic books about large-company management were ill-suited for early-stage ventures. It offered a reexamination of the existing product-introduction process and delineated a radically different method that brings customers and their needs headfirst into the process long before the launch.

We are building the first management tools specifically for startups.

At the time I wrote it, the book was my proposed methodology for getting startups right. But just as it was published, agile engineering became the preferred product-development method. This iterative and incremental method created a need and a demand for a parallel process to provide rapid and continual customer feedback. The [Customer Development process](#) I articulated in *The Four Steps* fit that need perfectly.

Over the past decade, thousands of scientists, engineers and MBAs in [my classes at Stanford’s engineering school](#) and U.C. Berkeley’s Haas School of Business—plus those sponsored by the [National Science Foundation](#)—have discussed, deployed, assessed and enhanced the Customer Development process. It has since been implemented by tens of thousands of entrepreneurs, engineers, and investors worldwide.

While the fundamental, powerful “Four Steps” remain at its core, this book is far more than a second edition. Nearly every step in the process, and in fact the entire approach, have been enhanced and refined based on a decade of Customer Development experience.

Customer development is paired with agile product development.

Even more gratifying: now, a decade later, multiple books and authors, are filling shelves in the newly created section for the strategy and science of entrepreneurship. Some of the other areas in this emerging field of

entrepreneurial management are:

- agile development, an incremental and interactive approach to engineering that enables product or service development to iterate and pivot to customer and market feedback
- business model design, which replaces static business plans with a nine-box map of the key elements that make up a company
- creativity and innovation tools for creating and fostering winning ideas
- the Lean Startup, an intersection of customer and agile development
- lean user interface design to improve web/mobile interfaces and conversion rates
- venture and entrepreneurial finance, to attract and manage funds that fuel the innovation

No one book, including this one, offers a complete roadmap or all the answers for entrepreneurs. Yet together, the texts in the entrepreneurial management science library offer entrepreneurs guidance where none existed before. Startups, driven by potential markets measured in billions of people, will use this body of knowledge to test, refine and scale their ideas far faster and more affordably than ever.

No one book, including this one, offers a complete roadmap...

My co-author Bob and I hope books like this one help speed the startup revolution and enhance its success—and yours.

Steve Blank

Pescadero, Calif., March 2012

Who Is This Book For?

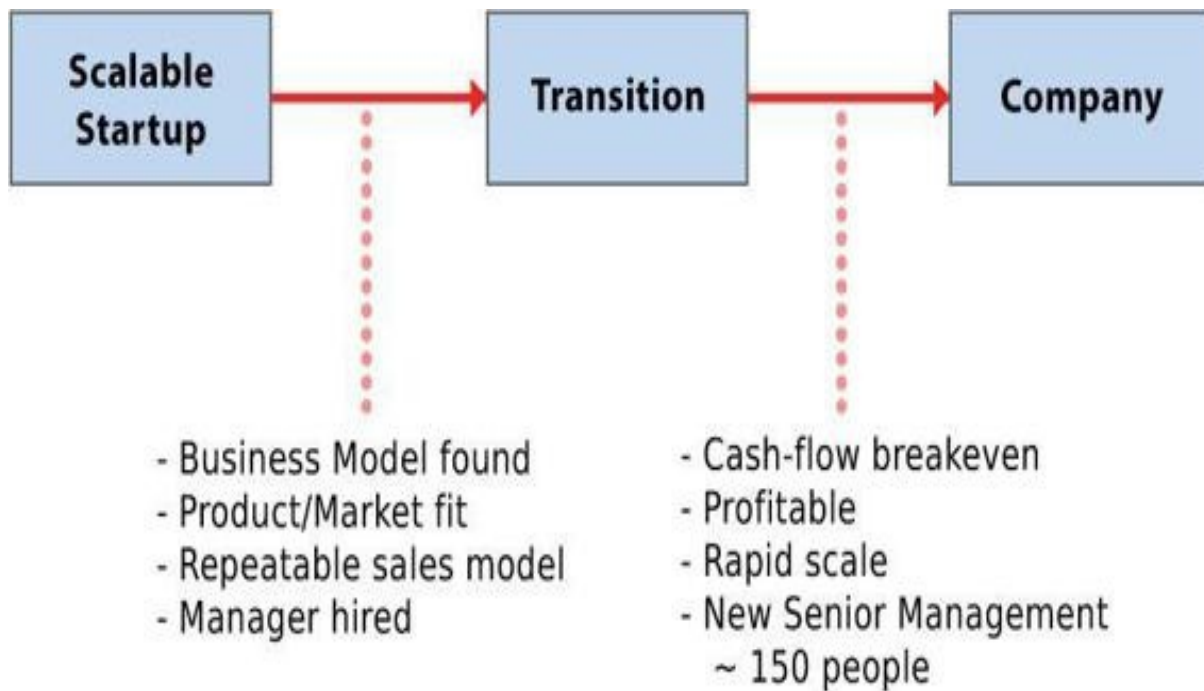
THIS BOOK IS FOR ALL ENTREPRENEURS and uses the term *startup* literally hundreds of times. But what exactly is a startup? [A startup is not a smaller version of a large company.](#) A startup is a temporary organization [in search of a scalable, repeatable, profitable business model.](#) At the outset, the startup business model is a canvas covered with ideas and guesses, but it has no customers and minimal customer knowledge.

But we've only defined the words *startup*, *entrepreneur*, and *innovation* halfway. These words mean different things in Silicon Valley, on Main Street, and in Corporate America. While each type of startup is distinct, this book offers guidance for each one.

A startup is a temporary organization in search of a scalable, repeatable, profitable business model.

Small Business Entrepreneurship: In the United States, the majority of entrepreneurs and startups are found among 5.9 million small businesses that make up 99.7 percent of all U.S. companies and employ 50 percent of all nongovernment workers. These are often service-oriented businesses like drycleaners, gas stations and convenience stores, where entrepreneurs define success as paying the owners well and making a profit, and they seldom aspire to take over an industry or build a \$100 million business.

Scalable startups are the work of traditional technology entrepreneurs. These entrepreneurs start a company believing their vision will change the world and result in a company with hundreds of millions if not billions of dollars in sales. The early days of a scalable startup are about the search for a repeatable and scalable business model. Scale requires external venture-capital investment in the tens of millions to fuel rapid expansion. Scalable startups tend to cluster in technology centers such as Silicon Valley, Shanghai, New York, Bangalore, and Israel and make up a small percentage of entrepreneurs, but their outsize return potential attracts almost all the risk capital (and press).



Scalable Startup (Figure i.1)

“Buyable” startups are a new phenomenon. With the extremely low cost of developing web/mobile apps, startups can literally fund themselves on founders’ credit cards and raise small amounts of risk capital, usually less than \$1 million. These startups (and their investors) are happy to be acquired for \$5 million to \$50 million, purchased by larger companies often to acquire the talent as much as the business itself.

Large Company Entrepreneurship: Large companies have finite life cycles. Most grow by offering new products that are variants of their core products (an approach known as *sustaining innovation*). They may also turn to *disruptive innovation*, attempting to introduce new products into new markets with new customers. Ironically, large companies’ size and culture make disruptive innovation (really an effort to launch a scalable startup inside a big company) extremely difficult to execute.

...large companies’ size and culture make disruptive innovation extremely difficult.

Social entrepreneurs build innovative nonprofits to change the world. Customer Development provides them a scorecard for assessing scalability, asset leverage, return on investment and growth metrics. These entrepreneurial ventures seek solutions rather than profits and happen on every continent in areas as diverse as water, agriculture, health, and

microfinance.

While the Customer Development process helps scalable startups the most, each of these five startup types has entrepreneurship and innovation at its heart. And each improves its chances for finding the right path to success through the use of Customer Development.

Who Is This Book Not For?

There are cases where using the Customer Development methodology and this book is inappropriate.

Early-stage ventures fall into two types: those *with customer/market risk* and those with *invention risk*.

- Markets with invention risk are those where it's questionable whether the technology can ever be made to work, but if it does, customers will beat a path to the company's door. (Think life sciences and cure for cancer.)
- Markets with customer/market risk are those where the unknown is whether customers will adopt the product.

For companies building web-based products, *product* development may be difficult, but with enough time and iteration, Engineering will eventually converge on a solution and ship a functional product—*it's engineering, not invention*. The real risk is in whether there is a customer and a market for the product as spec'ed. In these markets *it's all about customer/market risk*.

There's a whole other set of markets where the risk is truly *invention*. These are markets where it may take five or even 10 years to get a product out of the lab and into production (e.g., biotech). Whether it will eventually work, no one knows, but the payoff can be so large that investors will take the risk. In these markets *it's all about invention risk*.

Startups solve customer and market risk by reading this book.

A third type of market has *both invention and market risk*. For example, complex new semiconductor architectures mean you may not know if the chip performs as well as you thought until you get first silicon. But then, because there might be entrenched competitors and your concept is radically new, you still need to invest in the Customer Development process to learn how to get

design wins from companies that may be happy with their existing vendors.

Startups solve invention risk by using simulation tools (computational fluid dynamics, finite element analysis, etc.). Startups solve customer and market risk by reading this book. When the issues are customer acceptance and market adoption, this book shows the path.

Introduction

A legendary hero is usually the founder of something—the founder of a new age, the founder of a new religion, the founder of a new city, the founder of a new way of life. In order to found something new, one has to leave the old and go on a quest of the seed idea, a germinal idea that will have the potential of bringing forth that new thing.

— Joseph Campbell, *The Hero with a Thousand Faces*

JOSEPH CAMPBELL POPULARIZED THE NOTION of an archetypal “hero’s journey,” a pattern that recurs in the mythologies and religions of cultures around the world. From Moses and the burning bush to Luke Skywalker’s meeting Obi-wan Kenobi, the journey always begins with a hero who hears a calling to a quest. At the outset of the voyage, the path is unclear and no end is in sight. Each hero meets a unique set of obstacles, but Campbell’s keen insight was that the outline of these stories is always the same. There are not a thousand different heroes but *one hero with a thousand faces*.

The hero’s journey is an apt way to think of startups. All new companies and new products begin with a vision—a hope for what could be and a goal few others can see. It’s this bright and burning founder’s vision that differentiates an entrepreneur from a big-company CEO and separates startups from existing businesses.

Founding entrepreneurs are out to make their vision and business real. To succeed, they must abandon the status quo, recruit a team that shares their vision, and strike out together on what appears to be a new path, often shrouded in uncertainty, fear and doubt. Obstacles, hardships and potential disaster lie ahead, and their journey to success tests more than financial resources—it tests their stamina, agility, and courage.

Take a new path, often shrouded in uncertainty, fear, and doubt.

Every entrepreneur is certain his or her journey is unique. Each travels down the startup path without a roadmap and believes that no model or

template could possibly apply. What makes some startups successful while others sell off the furniture often seems like luck. But it isn't. As Campbell suggests, *the outline is always the same*. The path to startup success is well-traveled and well-understood. There is a true and repeatable path to success. This book charts that path.

A Repeatable Path

In the last quarter of the 20th century, startups thought they knew the correct path for the startup journey. They adopted a methodology for product development, launch, and life-cycle management almost identical to the processes taught in business schools for use in large companies. These processes provide detailed business plans, checkpoints and goals for every step toward getting a product out the door—sizing markets, estimating sales, developing marketing-requirements documents, prioritizing product features. Yet at the end of the day, even with all these processes, the embarrassing fact is that in companies large and small, established corporate giants as well as new startups, more than nine of 10 new products fail. It's true in every product category—high-tech or low, online or off, consumer or business—well-funded or not.

Even after decades of similar failures, investors are always surprised when a new venture fails to execute its business “plan.” *And still they continue to rely on the same product-introduction processes.*

We now know what the problem is. Startups have been using tools appropriate for executing a known business. [But startups are all about unknowns](#). To find the path to build a winning startup, entrepreneurs must try a new way:

Winners throw out the traditional product management and introduction processes they learned at existing companies. Instead, they combine agile engineering and Customer Development to iteratively build, test and search for a business model, turning unknowns into knowns.

Winners also recognize their startup “vision” as a series of untested hypotheses in need of “customer proof.” They relentlessly test for insights, and they course-correct in days or weeks, not months or years, to preserve cash and eliminate time wasted on building features and products that customers don't want.

Winners recognize their startup is a series of untested hypotheses.

Losers blindly execute a rigid product management and introduction methodology. They assume that the founder's vision drives the business strategy and product development plans and that all they need to do is to raise funds for execution.

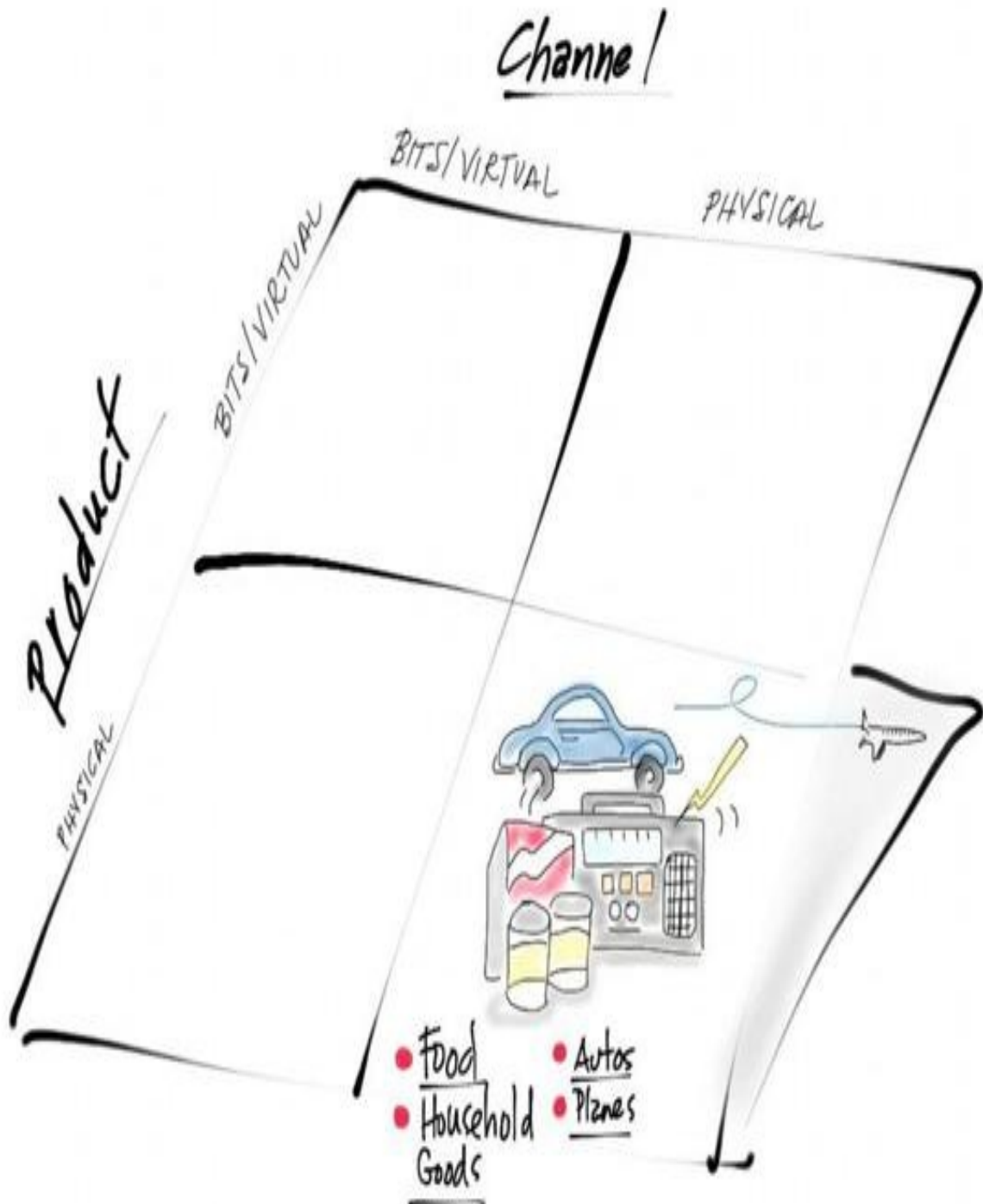
Founders, not employees, must search for a business model. The best way to search is for the *founders themselves* to *get out of the building* to gain a deep, personal, firsthand understanding of their potential customers' needs *before* locking into a specific path and precise product specs. That's the difference between winners and losers. It's also the Customer Development process detailed in this book.

Why a Second Decade?

Startups have now been using Customer Development for a decade, since the initial publication of *The Four Steps to the Epiphany*. If this is your first contact with the *Four Steps*, welcome aboard. For the tens of thousands who've embraced that first version, *The Startup Owner's Manual* offers a great deal more. The first version assumed startups were high-tech ventures in Silicon Valley selling products through a physical sales channel and aiming to be billion-dollar businesses. A lot has happened in 10 years, and this version embraces those changes. For example:

Bits: [The Second Industrial Revolution](#)

For thousands of years after the invention of the wheel, a *product* was a physical object one could touch, such as food, cars, planes, books, and household goods. These physical products reached customers via a physical sales *channel*: salespeople visiting customers, or customers visiting stores. [Figure i.2](#) shows this intersection of *physical products sold through a physical channel*.



Physical Products Sold Through a Physical Channel (Figure i.2)

One of the breakthroughs in commerce was the invention of products that were *ideas or promises that didn't exist in physical form*, such as life and health insurance, stocks and bonds, and commodity futures.

In the 1970s, software began to be sold as a product unbundled from any particular computer. The ability to purchase *bits* was a new concept. By themselves the bits were useless, but when combined with a computer in the form of software applications, bits solved problems or amused people (word

processing, balancing checkbooks, game play). These software applications and entertainment, all in the form of bits, were sold to consumers through specialized retail computer stores, a physical channel.



Software Products Sold Through Physical Channels (Figure i.3)

Still other software applications were designed to solve problems companies had (database access, manufacturing automation, sales automation), and added the upper right box to [Figure i.3](#), Software Products

Sold Through Physical Channels.

As the Internet created a new form of sales channel, a new class of company emerged with the value proposition to sell physical products over the Internet. Amazon, Zappos, Dell, and a whole raft of other e-commerce companies filled a new niche: *physical products sold via a web channel*. This new sales channel created massive disruption in the existing world of physical distribution, as book and music retailers perhaps know best of all.



Physical Products in Web/Mobile Channels (Figure i.4)

Over the past decade a new class of product has emerged, where *BOTH the product and the channel are bits* (see [Figure i.5](#)). Startups can now be built for thousands rather than millions of dollars and in weeks rather than years. As a result, the number of startups founded each year has exploded. New applications such as social networks that duplicate the socialization we once had face-to-face are being mediated via machine. Search engines that scour the web, such as Google and Bing, exist only in bits, in a web/mobile channel.

More important, entire industries that started by selling physical products in physical locations have begun their migration to bits sold over the Internet. Originally, people sold books, music, videos, movies, travel, and stocks and bonds either face-to-face or in storefronts. Those channels are either radically transformed or disappearing as physical products turn into bits.



Software Products In Web/Mobile Channels (Figure i.5)

Speed, Time and Iterations: the “Second Industrial Revolution”

Regardless of the business, any enterprise focused on the bottom righthand box in [Figure i.2](#)—Physical Goods Sold through a Physical Channel—has

discovered over the past decade that the old rules and tools for physical businesses and channels no longer apply. They've learned that the closer a company gets to a web/mobile channel and a web/mobile product, the faster it can change, test and optimize both *product and offer*. They need a new process to quickly adapt to the new freedoms a web/mobile channel and product allow, and they've found it in Customer Development.

The Customer Development process gathers customer feedback about product, channel, price, and positioning, all of which can be modified and tested in near-real time, and uses it as immediate feedback to iterate and optimize. As a result, web/mobile channel startups can move forward at "Internet speed," an impossibility with physical distribution channels and products.

A mere decade ago, getting feedback on the features of a video game required recruiting focus groups to come in and play the game while being observed through one-way mirrors. Today, companies like Zynga test and tune the features of their online games in days. Are sales slow because the game is too hard? You can adjust the scoring or other game variables and change the product itself quicker than you can say touchdown.

Customer Development is the process to organize the search for the business model.

Theoretically, when startups' products and channels are bits, they can gather and act on information 100 times faster than companies delivering physical goods via physical sales channels (10 times the number of iterative learning cycles, each using only 10 percent of the cash.) In fact, companies like Facebook, Google, Groupon, and Zynga grew faster in a decade than most industrial corporations grew in the 20th century. That's why we call it the Second Industrial Revolution.

The Four Steps: A New Path

The core of Customer Development is blissfully simple: Products developed by founders who get out in front of customers early and often, win. Products handed off to sales and marketing organizations that are only tangentially involved in the new-product development process will lose. There are no facts inside your building, *so get the heck outside*. Getting out of the building means acquiring a deep understanding of customer needs and combining that knowledge with incremental and iterative product development. The mix of Customer Development and Agile engineering dramatically increases the odds of new product and company success, while reducing the need for upfront cash and eliminating wasted time, energy, money and effort.

There are no facts inside your building, *so get the heck outside*.

Customer Development recognizes the startup's mission as a relentless search to refine its vision and idea, and to make changes in every aspect of the business invalidated during the search process. An entrepreneur seeks to test a series of unproven hypotheses (guesses) about a startup's business model: who the customers are, what the product features should be, and how this scales into a hugely successful company. Customer Development recognizes a startup is *a temporary organization* built to search for the answers to what makes a repeatable and scalable business model. Customer Development is *the process to organize that search*.

CHAPTER 1

The Path to Disaster: A Startup Is Not a Small Version of a Big Company

The definition of insanity is doing the same thing over and over and expecting different results.

—Albert Einstein

WHILE THIS STORY IS OLD, ITS LESSONS are timeless. In the heyday of the dot-com bubble at the end of the 20th century, [Webvan](#) stood out as one of the most electrifying new startups, with an idea that would potentially touch every household in America. Raising one of the largest financial war chests ever seen (more than \$800 million), the company aimed to revolutionize the \$450 billion retail grocery business with online ordering and same-day door-to-door grocery delivery. Webvan believed this was one of the first “killer applications” for the Internet. Customers could just point, click, and order. Webvan’s CEO told *Forbes* magazine that Webvan would “set the rules for the largest consumer sector in the economy.”

Beyond amassing megabucks, the Webvan entrepreneurs seemed to do everything right. Backed by experienced venture-capital investors, the company raced to build vast automated warehouses and bought fleets of delivery trucks while building an easy-to-use website. Webvan hired a seasoned CEO from the consulting industry. What’s more, most initial customers actually liked the service. But barely 24 months after the initial public offering, Webvan was bankrupt and out of business. What happened?

...barely 24 months after the initial public offering, Webvan was bankrupt.

This was not a failure of execution. Webvan did everything its board and investors asked. In particular, the company fervently followed the traditional new-product introduction model commonly used by most new ventures and embraced the mantras of the time: “first mover advantage” and “get big fast.”

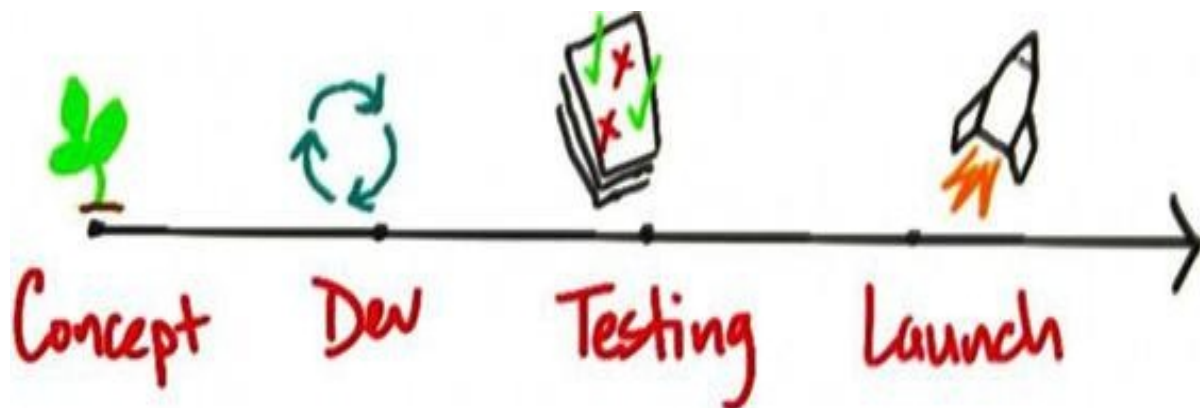
Webvan’s failure to ask “where are the customers?” illuminates how this tried-and-true model led one of the best-funded startups of all time down the path to disaster.

The Traditional New-Product Introduction Model

In the 20th century, every company bringing a new product to market used some form of product management model (Figure 1.1). Emerging early in the century, this product-centric model described a process that evolved in manufacturing industries. The consumer packaged-goods industry adopted it in the 1950s, and it spread to the technology business in the last quarter of the century. There it became an integral part of the startup culture.

At first glance, the new-product introduction model outlined in the diagram at right appears to be helpful and benign. It illustrates the process of getting a new product into the hands of waiting customers. A new product moves from development to customer testing (alpha/beta test), and using feedback from this initial testing, the product engineers fix technical errors in the product until the product launch date and first customer ship.

The new-product introduction model is a good fit for an existing company where the customers are known, the product features can be spec’ed upfront, the market is well-defined, and the basis of competition is understood.



New Product Introduction Diagram (Figure 1.1)

As for startups, a scant few fit these criteria. Few even know who their customers are. Yet many persist in using the new-product introduction model not only to manage product development but as a roadmap for finding customers and setting the timing for the startup’s sales, launch and revenue plans. Investors use the new-product introduction diagram to set and plan funding. All parties involved in the startup use a roadmap leading toward a very different location, yet they’re surprised to end up lost.

What's wrong with the old model, and how did it contribute to the billion-dollar Webvan implosion?

Concept and Seed Stage

At the concept and seed stage, founders capture their passion and vision for the company, sometimes on the back of a napkin, and turn them into a set of key ideas, which becomes the outline for the *business plan*.

Next, issues surrounding the product are defined. What is the product or service concept? What are the product features and benefits? Can it be built? Is further technical research needed? Who will the customers be, and where will they be found? Statistical and market research and a few customer interviews fuel the evaluation and business plan.

This step also brings forth a first guess at how the product will ultimately reach the customer, including discussions of competitive differences, distribution channels, and costs. An initial positioning chart explains the company and its benefits to venture capitalists or corporate higher-ups. The business plan now gets market-size, competitive and financial sections, with an appendix containing Excel spreadsheets forecasting revenue and expenses. Creative writing, passion and shoe leather combine in the concept and seed phase in hopes of convincing an investor to fund the company or the new division.

Once a waterfall process starts, the proverbial train has left the station...

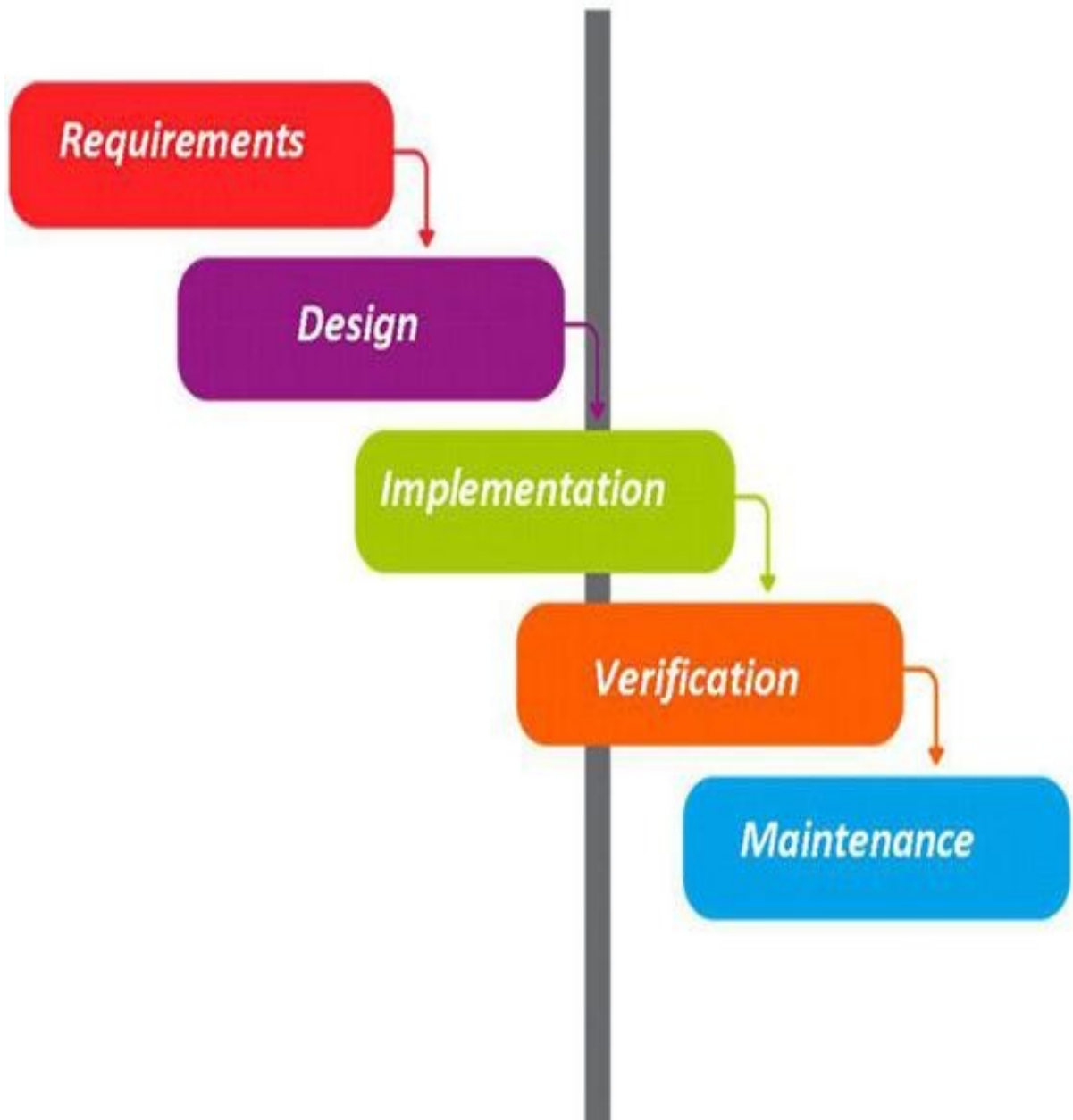
Webvan did all of this extremely well. Founded in December 1996, with a compelling story and a founder with a track record, Webvan raised \$10 million from leading Silicon Valley venture capitalists in 1997. In the next two years, additional private rounds totaling an unbelievable \$393 million followed before the company's IPO.

Product Development

In stage two, product development, everyone stops talking and starts working. The respective departments go to their figurative corners as the company begins to specialize by function. Marketing refines the size of the market defined in the business plan and begins to target the first customers. In a well-

organized startup (one with a fondness for process), the marketing folk might even run a focus group or two on the market they think they're in and work with Product Management on a market requirements document (MRD) for engineering to specify the product's final features and functions. Marketing starts to build a sales demo, writes sales materials (websites, presentations, data sheets), and hires a pr agency. In this stage, or by alpha test, the company traditionally hires a VP of Sales.

Meanwhile, Engineering focuses on specifying and then building the product. The simple box labeled "Product Development" typically expands into a "waterfall" or "spiral" or incremental process of interlacing steps, all focused on minimizing development risk of a defined feature set ([Figure 1.2](#)). This process starts with the founder's vision, which may be expanded into an MRD (and a product requirements document), and expands further into detailed engineering specifications. With those in hand, Engineering begins implementation fueled by cold pizza and long nights and weekends. Once a waterfall process starts, the proverbial train has left the station and the product is nearly impossible to revise. As a rule, the "train" can run almost nonstop for 18 or perhaps 24 months or more, uninterrupted by changes or new ideas no matter how good they might be for the business.



The Product Development “Waterfall” Model (Figure 1.2)

In Webvan’s case, Engineering moved along two fronts: building the automated warehouses and designing the website. The automated warehouses were a technological marvel, with automated conveyors and carousels transporting food items off the shelves to workers who packed them for delivery. Webvan also designed its own inventory, warehouse, and route management systems and software to manage the entire customer order and delivery process. This software communicated with the Webvan website and issued order-fulfillment instructions to the distribution center. Once a delivery was scheduled, the system’s custom route-planning feature determined the most efficient route for delivering the goods to customers’ homes.

At the same time, planning began for a marketing and promotion

program designed to strengthen the Webvan brand name, get customers to try the service in the first target market, build strong customer loyalty, and maximize repeat usage and purchases. The plan was to build Webvan's brand name (down to stickering every cup holder in San Francisco's AT&T Park) and customer loyalty through public relations programs, advertising campaigns and promotional activities. Spending for all these activities was part of the business plan.

Alpha/Beta Test

In stage three, the alpha/beta test, Engineering continues building along the classic waterfall development model, working toward the first customer ship date. And, by beta test time, working with a small group of outside users to test the product and ensure that it works as specified. Marketing develops a complete marketing communications plan, sets up the corporate website, provides Sales with a full complement of support materials, and starts the public relations bandwagon rolling. The pr agency polishes the positioning and starts contacting the long-lead-time press and blogs, while Marketing starts the branding activities.

Sales signs up the first beta customers (who may volunteer to pay for the privilege of testing a new product), begins to build the selected distribution channel, and staffs and scales the sales organization outside headquarters. The sales VP works toward achieving the revenue plan as specified in the business plan. Investors and board members start measuring progress by the number of orders in place by first customer ship. The CEO hits the streets and the phone or the parent-company headquarters, searching for additional capital.

Webvan began to beta-test its grocery delivery service in May 1999 with about 1,100 customers. At the same time, the marketing buzz started with a pr blitz with hundreds of articles touting the newest entrant in the online grocery business. Private investors poured hundreds of millions of dollars into the company.

Product Launch and First Customer Ship

With the product working (sort of), the company goes into "big-bang" spending mode. The product and the company are launched. The company has a large press event, and Marketing launches a series of programs to create end-user demand. In anticipation of sales, the company hires a national sales organization; the sales channel has quotas and sales goals. The board begins measuring company performance based on sales execution against its

business plan, albeit one typically written at least a year earlier, when the company first sought investment.

Building a sales channel and supporting marketing burn a lot of cash. Assuming no early liquidity event for the company, more fund-raising is often required. The CEO looks at the product-launch activities and the scale-up of the sales and marketing team and goes out yet again, palm up, to the investor community. (In the dot-com bubble economy, investors used an IPO at product launch to take the money and run, before there was a track record of success or failure.) This operational model no doubt sounds familiar to many: a product- and process-centric model used by countless startups to take their first products to market.

Webvan launched its first regional web store in June 1999 (just a month after starting beta test) and filed for its public offering 60 days later. The company raised \$400 million and had a market capitalization of \$8.5 billion the day of its IPO—larger than the market cap of the top three grocery chains combined. The elation was short-lived.

The 9 Deadly Sins of the New Product Introduction Model

For new products like Webvan, the business plan fails as a roadmap because both the product and the customer are unknown. For most startups, these nine flawed assumptions are the most toxic of all:

1. Assuming “I Know What the Customer Wants”

First is the founder’s unwavering belief that he or she understands who the customers will be, what they need, and how to sell it to them. Any dispassionate observer would recognize that on Day One, a startup has no customers, and unless the founder is a true domain expert, he or she can only guess about the customer, problem, and business model. On Day One, a startup is a *faith-based* initiative built on guesses. Yet the traditional product introduction methodology has founders take these many business model guesses as facts and go design a product and start spending money to build it on a race to “first customer ship”—all before talking to a single customer.

On Day One, a startup is a *faith-based* initiative...

To succeed, founders need to turn hypotheses or guesses into facts as soon as possible by getting out of the building, asking customers if the hypotheses were correct, and quickly changing those that were wrong.

2. The “I Know What Features to Build” Flaw

The second flawed assumption is implicitly driven by the first. Founders, presuming they know their customers, assume they know all the features customers need. These founders specify, design, and build a fully featured product using classic product development methods without ever leaving their building. But wait— isn’t that what startups *should* do? No—that’s what companies with existing customers do.

...it’s unknown whether the features appeal to customers.

The [waterfall development process](#) proceeds sequentially and without interruption for as long as a year or two. Progress is measured by each new line of code written or new piece of hardware built throughout the process until the product is released. Yet without direct and continuous customer contact, *it's unknown whether the features appeal to customers*. Fixing the inevitable product mistakes after building and shipping the entire product is costly and time-consuming, if not deadly. It can render the product obsolete by launch. Worse, it often causes huge engineering waste, with hundreds of hours of work tossed aside, or tons of code cut and dropped to the floor, when customers say the new features aren't ones they care about. Ironically, startups were often crippled by the very methodology they traditionally used to build new products.

3. Focus on Launch Date

The traditional product introduction model focuses engineering, sales and marketing on the all-important, immovable launch date. Marketing tries to pick an “event” (trade show, conference, blog, etc.) where they can “launch” the product. Executives look at that date and the calendar, working backward to ignite fireworks on the day the product is launched. Neither management nor investors tolerate “wrong turns” that result in delays. In fact, traditional engineering schedules have test cycles with the names *alpha*, *beta*, and *release* but rarely allow time to improve the product. They're still geared to putting out the original product with minimal bugs, though.

The product launch and first customer ship dates are merely the dates when a product development team thinks the product's first release is “finished.” It doesn't mean the company understands its customers or how to market or sell to them, yet in almost every startup, ready or not, departmental clocks are set irrevocably to “first customer ship.” Even worse, a startup's investors are managing their financial expectations by this date as well.

The chorus of investor voices says, “Why, of course that's what you do. Getting the product to market is what sales and marketing people do in startups. That's how a startup makes money.” This is deadly advice. Ignore it. Focusing only on launch results in a “fire, ready, aim” strategy that ignores the customer discovery process—a fundamental and generally fatal error. Obviously, every startup or company wants to get a product to market and sell it, but that can't be done until the company understands *who* it's selling to and *why* they'll buy. The forced march ignores the iterative loop that says, “If our

assumptions are wrong, maybe we need to try something different.” It shuts off the “build, test and learn” flow and assumes that customers will come based merely on good engineering execution.

Time after time, only after launch does a startup discover that not enough customers visit its website, play the game, bring their friends, or convert to orders. Or it discovers that early customers don’t scale into a mainstream market, or the product doesn’t solve a high-value problem, or the cost of distribution is too high. While those discoveries are bad enough, the startup is now burdened with an expensive, scaled-up sales and marketing organization—effective only at burning mountains of cash—that’s now trying to figure out what went wrong and how to fix it.

At Webvan, the dot-com mania may have intensified the company’s drive to launch, but its single-minded focus was typical of most startups. At first customer ship, Webvan had close to 400 employees. It hired more than 500 more during the next six months. By May 1999, the company had opened its first \$40 million distribution center, built and scaled for a customer base it could only guess at, and it had committed to 15 other distribution centers of the same size. Why? Because the Webvan business plan said to do so, regardless of whether the customers agreed.

4. Emphasis on Execution Instead of Hypotheses, Testing, Learning, and Iteration

Startup cultures emphasize “get it done, and get it done fast.” So it’s natural that heads of engineering, sales and marketing all believe they are hired for *what they know how to do, not what they can learn*. They assume that their experience is relevant to this new venture and that all they need do is put that knowledge to work managing the execution that’s worked for them before.

While established companies *execute* business models where customers, problems, and necessary product features are all knowns, startups need to operate in a “*search*” mode as they test and prove every one of their initial hypotheses. They learn from the results of each test, refine the hypothesis and test again, all in search of a repeatable, scalable and profitable business model.

Relentless execution without knowing what to execute is a crime.

In practice, startups begin with a set of initial hypotheses (guesses), most of which will end up being wrong. Therefore, focusing on execution and delivering a product or service based on those initial, untested hypotheses is a going-out-of-business strategy.

In contrast, the traditional product introduction model assumes that building a startup is a step-by-step, sequential, execution-oriented process. Each step unfolds in a logical progression that can be captured in a PERT chart (a project management technique that maps the steps and time required for project completion), with milestones and resources assigned for the completion of each step. But anyone who has ever taken a new product out to a set of potential customers knows that a good day in front of customers is two steps forward and one step back. The ability to learn from these missteps distinguishes a successful startup from those that have vanished.

Like all startups focused on executing to a sequential product introduction plan, Webvan hired vice presidents of merchandising, marketing and product management—all oriented around executing a given sales and marketing strategy instead of listening to customers and discovering customer needs. Sixty days after first customer ship, those three VPs employed more than 50 people.

The ability to learn from missteps distinguishes a successful startup.

5. Traditional Business Plans Presume No Trial and No Errors

The one great advantage of the traditional product development model: it provides boards and founders an unambiguous path with clearly defined milestones the board *presumes* will be achieved. Most engineers know what *alpha test*, *beta test*, and *first customer ship* mean. If the product fails to work, everyone stops to fix it. In stark contrast, before first customer ship, sales and marketing activities are ad hoc and fuzzy, and seldom have measurable, concrete objectives. They lack any way to stop and fix what's broken (and don't even know *if* it's broken or *how* to stop).

Financial progress is tracked using metrics like income statement, balance sheet and cash flow even when there's no revenue to measure. In

reality, none of these are useful for startups. Board directors have simply adopted the traditional metrics used in large companies with existing customers and known business models. In a startup, these metrics don't track progress against the startup's only goal: *to find a repeatable and scalable business model*. Instead, traditional metrics get in the way.

Instead of asking, "How many days to the beta test?" or, "What's in our sales pipeline?" a startup's board and management team need to ask specific questions about results of its long list of tests and experiments to validate all components of its business model.

If a startup's board of directors isn't asking these kinds of questions, it's wasting time without adding value. No matter what, directors and founders must stay focused on one financial metric that always matters: cash burn rate and number of months' worth of cash left in the bank.

If a startup's board of directors isn't asking these kinds of questions, it's wasting time...

Webvan had no milestones saying, "Stop and evaluate the launch results." Otherwise, it might have noticed the stark contrast between the 2,000 daily orders it was getting and the 8,000 in the business-plan forecast. Before any meaningful customer feedback was in hand and only a month after shipping began, Webvan signed a \$1 billion deal (yes, \$1,000,000,000) with Bechtel to build 26 additional distribution centers over the next three years.

6. Confusing Traditional Job Titles with What a Startup Needs to Accomplish

Most startups have simply borrowed job titles from established companies. But remember, these are jobs in an organization that's executing a *known* business model. The title *Sales* in an existing company reflects a team repeatedly selling a known product to a well-understood group of customers with standard presentations, prices, terms, and conditions. Startups by definition have few if any of these known elements. In fact, they're out searching for them!

Because target customers, product specs and product presentations may change daily, early-stage startup executives need dramatically different skills from executives who are working in an established company selling

established products or line extensions. The demands of customer discovery require people who are comfortable with change, chaos, and learning from failure and are at ease working in risky, unstable situations without a roadmap. In short, startups should welcome the rare breed generally known as entrepreneurs. They're open to learning and discovery—highly curious, inquisitive, and creative. They must be eager to *search* for a repeatable and scalable business model. Agile enough to deal with daily change and operating “without a map.” Readily able to wear multiple hats, often on the same day, and comfortable celebrating failure when it leads to learning and iteration.

Webvan's CEO and VPs all came from large-company backgrounds and experience. They were surprised and uncomfortable with the chaos of a startup and tried to solve the problem by scaling the company rapidly.

...measuring progress against a product launch or revenue plan is simply false progress.

7. Sales and Marketing Execute to a Plan

Hiring VPs and execs with the right titles but the wrong skills leads to further startup trouble as high-powered sales and marketing people arrive on the payroll to execute the “plan.” Here's how it typically unfolds:

Following the business plan and the traditional product introduction model, the board and founders agree to a launch date, a burn rate, a revenue plan and a set of milestones. The sales VP begins to hire the core sales team, design sales pitches, and make appointments and attempts to acquire early “lighthouse” customers (prominent customers who will attract others). At the same time, the sales team uses revenue goals specified in the business plan to track its progress in understanding customers. Meanwhile, the marketing VP is busy designing websites, logos, presentations, data sheets and collateral, and hiring pr agencies to create buzz. These tactics become marketing objectives, *even though they're merely tactics*. Marketing discovers whether its positioning, messaging, pricing and demand-creation activities will work *only after first customer ship*.

Executives and board members accustomed to measurable signs of progress against “the plan” will focus on these execution activities because this is what they know how to do (and what they believe they were hired to

do). Of course, in established companies with known customers and markets, this focus makes sense. And even in some startups in “existing markets,” where customers and markets are known, it might work. But in a majority of startups, measuring progress against a product launch or revenue plan is simply false progress, since it transpires in a vacuum absent real customer feedback, instead of searching for an understanding of customers and their problems and replacing assumptions with facts.

Webvan set off on this kind of plan-driven “marketing death march.” In its first six months, it acquired an impressive 47,000 new customers, but 71 percent of its 2,000 daily orders were repeat orders, which meant Webvan needed to quickly secure many more new customers and reduce its high customer attrition rate. Making matters worse, Webvan had scaled its spending based on unverified and, it turned out, highly optimistic marketing guesses.

8. Presumption of Success Leads to Premature Scaling

The business plan, its revenue forecast, and the product introduction model assume that every step a startup takes proceeds flawlessly and smoothly to the next. The model leaves little room for error, learning, iteration or customer feedback. Nothing says, “Stop or slow down hiring until you understand customers,” or, “pause to process customer feedback.” Even the most experienced executives are pressured to hire and staff per the plan regardless of progress. This leads to the next startup disaster: *premature scaling*.

In large companies, the mistakes just have additional zeros in them.

Hiring and spending should accelerate only after sales and marketing have become predictable, repeatable, scalable processes—not when the plan says they’re scheduled to begin (or when the “lighthouse” account is signed or a few sales are made).

In large companies, the mistakes just have additional zeros in them. Microsoft and Google, powerhouses though may they be, launch product after product—Google’s Orkut and Wave, Deskbar, Dodgeball, Talk and Finance; Microsoft’s “Kin,” Vista, Zune, “Bob,” WebTV, MSNTV, PocketPC—on rigid schedules driven by “the model” and the presumption of success.

Shortly thereafter, a lack of customer response delivers a fast, quiet funeral for product and management alike.

At Webvan, premature scaling permeated a company culture dominated by the prevailing venture-capital mantra of the time, “get big fast.” It spent \$18 million to develop proprietary software and \$40 million to set up its first automated warehouse before it had shipped a single item. Premature scaling had dire consequences, assuring that the Webvan case will be taught in business schools for decades to come. As customer demand failed to live up to Webvan’s business plan, the company slowly realized it had overbuilt and overdesigned. While Webvan had executed to its plan, it had also failed to pay attention to its customers.

...no business plan survives first contact with customers.

9. Management by Crisis Leads to a [Death Spiral](#)

At Webvan, the consequences of all the mistakes began to show by the time of first customer ship. The story usually unfolds like this:

Sales starts to miss its numbers and the board becomes concerned. The sales VP arrives at a board meeting, still optimistic, and provides a set of reasonable explanations. The board raises a collective eyebrow. The VP returns to the field to exhort the troops to work harder. Sales asks Engineering to build custom versions of the product for special customers, since this is the only way that the increasingly desperate sales force can close the sale. Board meetings become increasingly tense. Shortly thereafter, the sales VP is probably terminated as part of the “solution.”

A new sales VP hired and quickly concludes that the company just didn’t understand its customers or how to sell them. She decides that the company’s positioning and marketing strategy were incorrect and that the product was missing critical features. Since the new sales VP was hired to “fix” sales, the marketing department must now respond to a sales manager who believes that whatever was created earlier in the company was wrong. (After all, it got the old VP fired, right?) A new sales plan buys the new sales VP a few months’ honeymoon.

Sometimes all it takes is one or two iterations to find the right sales

roadmap and positioning to attract exuberant customers. In tougher times, when dollars are tighter, the next round of funding may never come.

But the problem at Webvan was not an incorrect sales strategy or positioning statement. The problem is that *[no business plan survives first contact with customers](#)*. The assumptions in the Webvan business plan were simply a series of untested hypotheses. When real results came in, they learned that the guesses in their revenue plan were wrong. Focusing on executing their business plans, Webvan iterated their strategy and their search for a business model by firing executives.

Failure is an integral part of the search for a business model.

Webvan went public in 1999, and its sea of red ink was reported quarterly for all to see. Rather than acknowledge its unrealistic plan and scale back or retrench, the company kept spending against its flailing strategy, accumulating a \$612 million deficit in the process. Seven months after its IPO, Webvan filed for Chapter 11 bankruptcy.

The ironic Webvan postscript: two other companies on two continents saw the same opportunity at the same time but developed their businesses by following Customer Development precepts even though they hadn't been published at the time. Peapod and Tesco are both successful, growing, and profitable today. They started smaller, without carving hypothetical assumptions and plans in stone, and learned what customers wanted as they developed business and financial models that worked. Tesco, a UK company that used retail stores as its launch pad and "warehouse," today delivers more than 85,000 orders a week and earns more than \$559 million in sales. Peapod, an American company, has delivered more than 10 million grocery orders to more than 330,000 customers. Explicitly or implicitly, both understood the test-and-iterate process of Customer Development.

CHAPTER 2

The Path to the Epiphany: The Customer Development Model

How narrow the gate and constricted the road that leads to life. And those who find it are few.

—Matthew 7:14

WHEN WILL HARVEY APPROACHED STEVE BLANK with a new business idea in June 2004, Steve uncharacteristically almost took out his checkbook before hearing Will's pitch. Steve had invested in Will's previous company, [There.com](#), and sat on its board. Before that, Will had been Steve's engineering VP at Rocket Science, a video-game company with Steve as founding CEO. Rocket Science is infamous for appearing on the cover of *Wired* magazine while blowing through \$35 million in venture capital in less than three years, leaving a crater so deep it has its own iridium layer.

Sitting in Steve's living room, Will explained his vision for IMVU, a "virtual world" company with 3D avatar-based instant messaging and social networking. Will had a world-class reputation. He developed Music Construction Set, a worldwide best-selling video game, at the age of 15. He earned his bachelor's, master's and Ph.D. in computer science at Stanford while running a video-game company that developed hits like *Zany Golf*, *Immortal*, and *Marble Madness*.

Will's co-founder, Eric Ries, had started an online recruiting company while earning his computer science degree at Yale. Eric had joined Will's last startup as a senior software engineer. That company built a "virtual world" on the web using a multiyear waterfall development model. After three years, the product was ready to launch with a big-bang product introduction guided by a hired big gun, a CEO with large company experience. Only then did they discover that customers didn't want or care about most of the features they had so painstakingly built.

Steve told the IMVU founders that in exchange for his check to help fund their seed round, they were required to audit his Customer Development class at U.C. Berkeley's Haas Business School. As the semester unfolded,