

THE HOMA FILES

Professor Ken Homa
Georgetown University



Discovery Driven Planning

Proprietary Material

© K.E. Homa

So, what's the problem?

- When evaluating the financial attractiveness of 'opportunities', most companies do detailed financial projections going out 3, 5, or 10 years ... or more.
- The financial projections are usually driven by 'point estimates' of demand (or sales) that are built on layers of assumptions and, thus, are difficult to forecast with any reasonable degree of precision.
- So, the financial projections themselves – while confidence building (perhaps) – are always imprecise ... and often flat-out wrong !

Discovery Driven Planning

to the rescue ...

Harvard Business Review

www.hbrreprints.org

MANAGER'S TOOL KIT

*New ventures require a new
way to plan.*

Discovery-Driven Planning

by Rita Gunther McGrath and Ian C. MacMillan

Classic publication: 1995 ... frequent re-publication and referrals

Discovery Driven Planning

Basic Premises

- Developing a forecast is harder than validating or refuting one (*i.e. “over or under” likelihood*)

So, work backwards ... determine how much you to have to sell to meet financial hurdles ... and then ask yourself: “Can we do it ?”

Discovery Driven Planning

Basic Premises

- Developing a forecast is harder than validating or refuting one (*i.e.* “over or under” likelihood)

So, work backwards ... determine how much you to have to sell to meet financial hurdles ... and then ask yourself: “Can we do it ?”

- Over time, learning occurs (*i.e.* “*discovery*”) and assumptions can be validated, refined, or refuted.

So, start with ‘what you know’, keep a list of what you don’t know, and refine your estimates when you know more

Discovery Driven Planning

The Process

- Specify required profitability

Various metrics available to choose from →

Financial Metrics

- DCF, NPV
- ROI, EVA
- B-E, Payback

Opinion: For start-up situations, key is getting to positive cash flow position ASAP (with fully loaded costs)

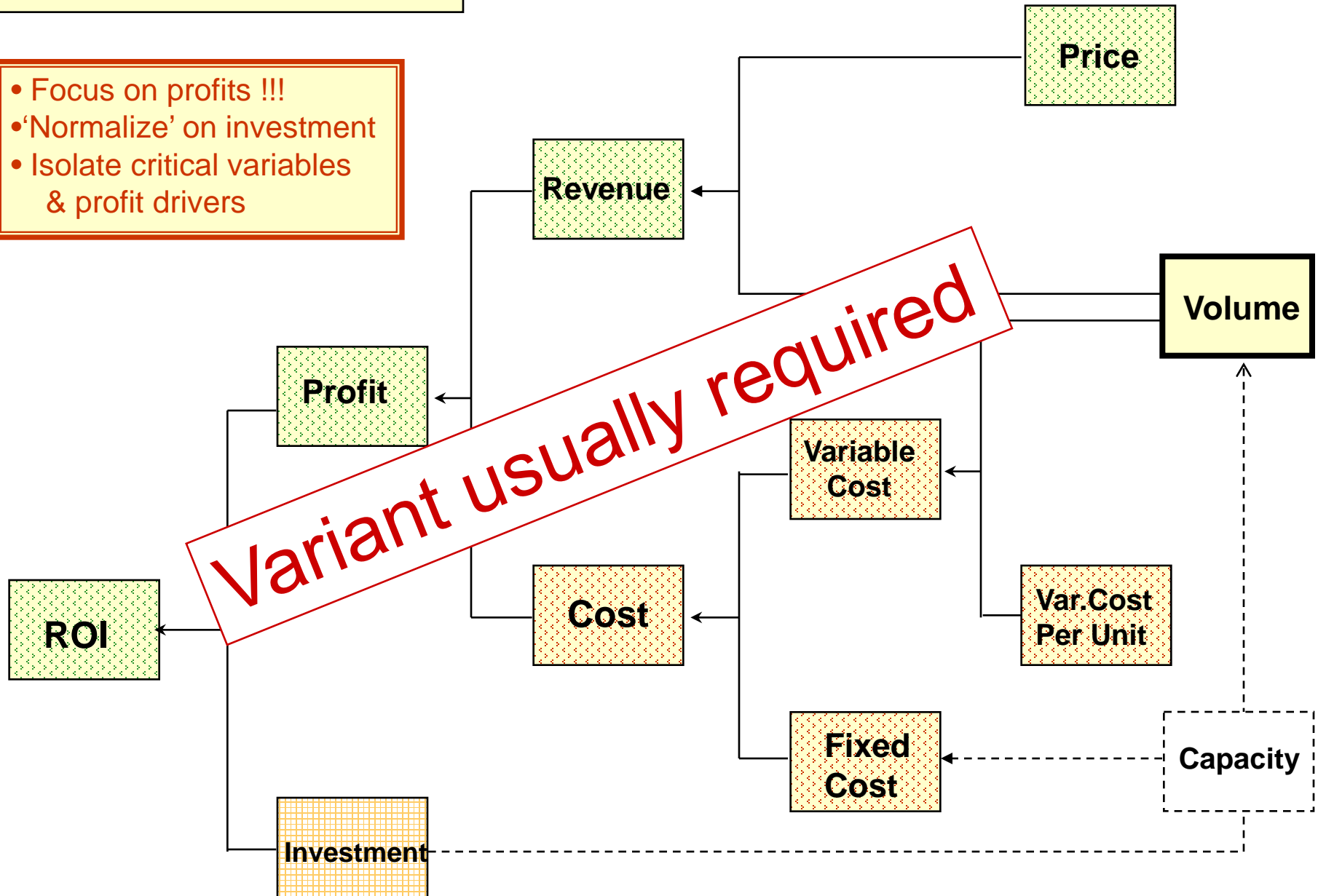
Discovery Driven Planning

The Process

- Specify required profitability
- Estimate major cost factors

Return on Investment

- Focus on profits !!!
- 'Normalize' on investment
- Isolate critical variables & profit drivers



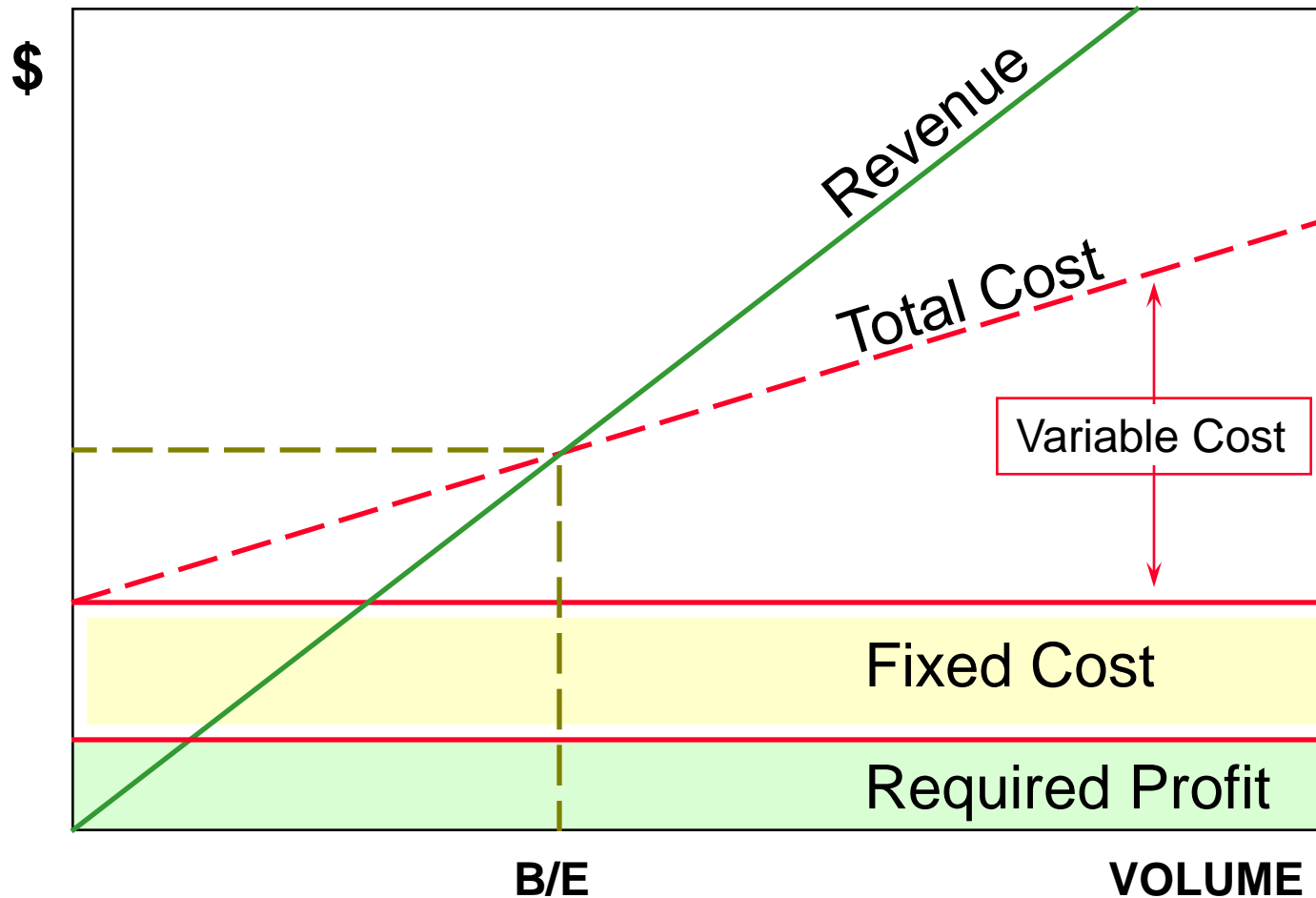
Variant usually required

Discovery Driven Planning

The Process

- Specify required profitability
- Estimate major cost factors
- Determine required sales level

Breakeven Analysis



Discovery Driven Planning

The Process

- Specify required profitability
- Estimate major cost factors
- Determine required sales level

Key
Reverse
Income (*P&L*)
Statement

Discovery Driven Planning

The Process

- Specify required profitability
- Estimate major cost factors
- Determine required sales level

Key
Reverse
Income (*P&L*)
Statement

It is much more difficult to develop and defend a point estimate than to assess the likelihood of meeting or exceeding a “go get” number.

Reverse Income Statement

Illustration

- Expect investment = \$1 million
- Set ROI hurdle @ 15%
- Implied profit hurdle = \$150,000

Reverse Income Statement

Illustration

- Expect investment = \$1 million
- Set ROI hurdle @ 15%
- Implied profit hurdle = \$150,000

- Project \$350,000 incremental fixed costs
- Project \$500,000 variable costs
- Total “allowable costs” = \$850,000

Reverse Income Statement

Illustration

- Expect investment = \$1 million
- Set ROI hurdle @ 15%
- Implied profit hurdle = \$150,000

- Project \$350,000 incremental fixed costs
- Project \$500,000 variable costs
- Total “allowable costs” = \$850,000

- Req'd profit + allowable costs = \$1 million

Reverse Income Statement

Illustration

- Expect investment = \$1 million
- Set ROI hurdle @ 15%
- Implied profit hurdle = \$150,000

- Project \$350,000 incremental fixed costs
- Project \$500,000 variable costs
- Total “allowable costs” = \$850,000

- Req’d profit + allowable costs = \$1 million
- To meet hurdle, req’d revenues = \$1 million

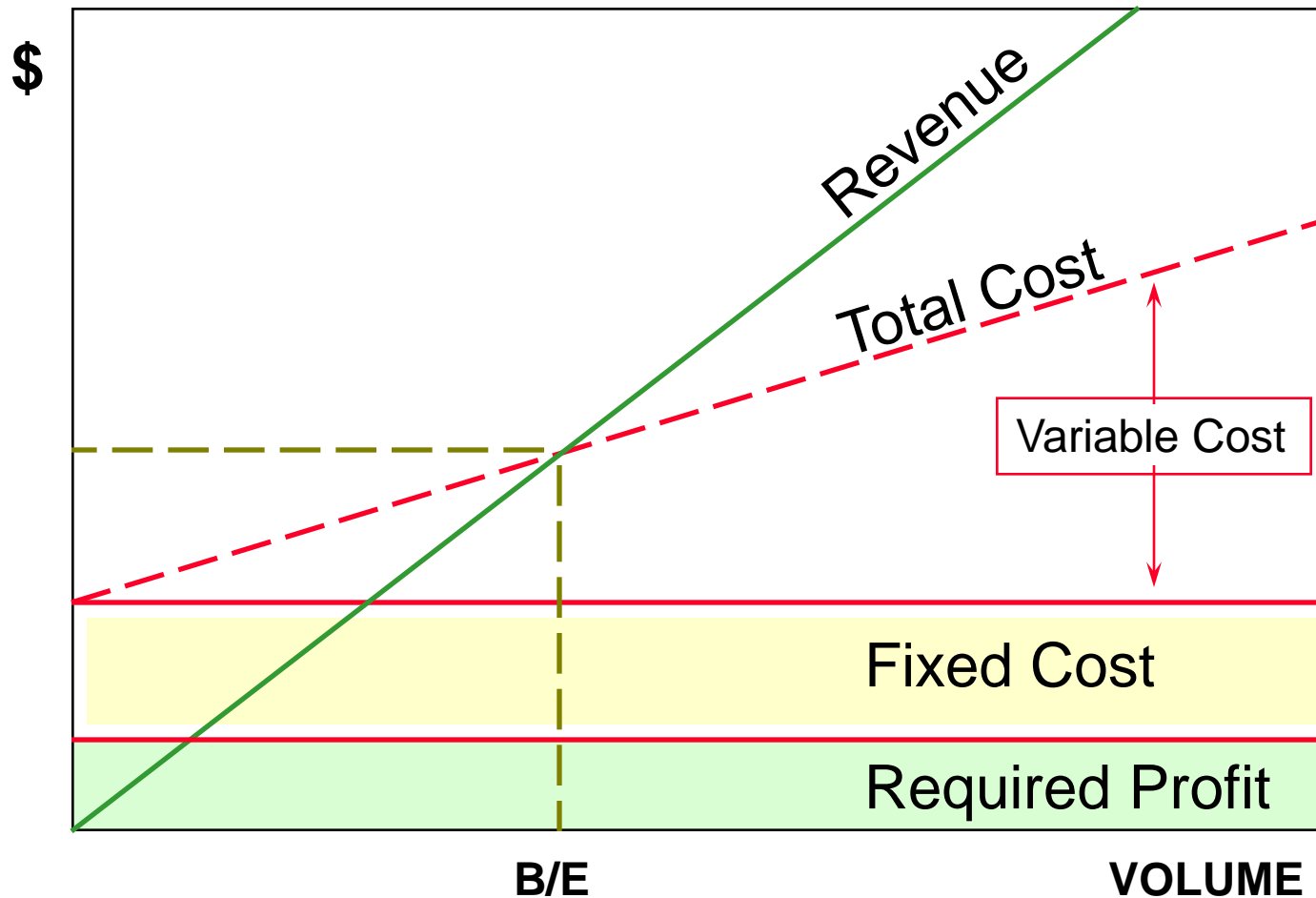
Not quite that easy ...

Reverse Income Statement

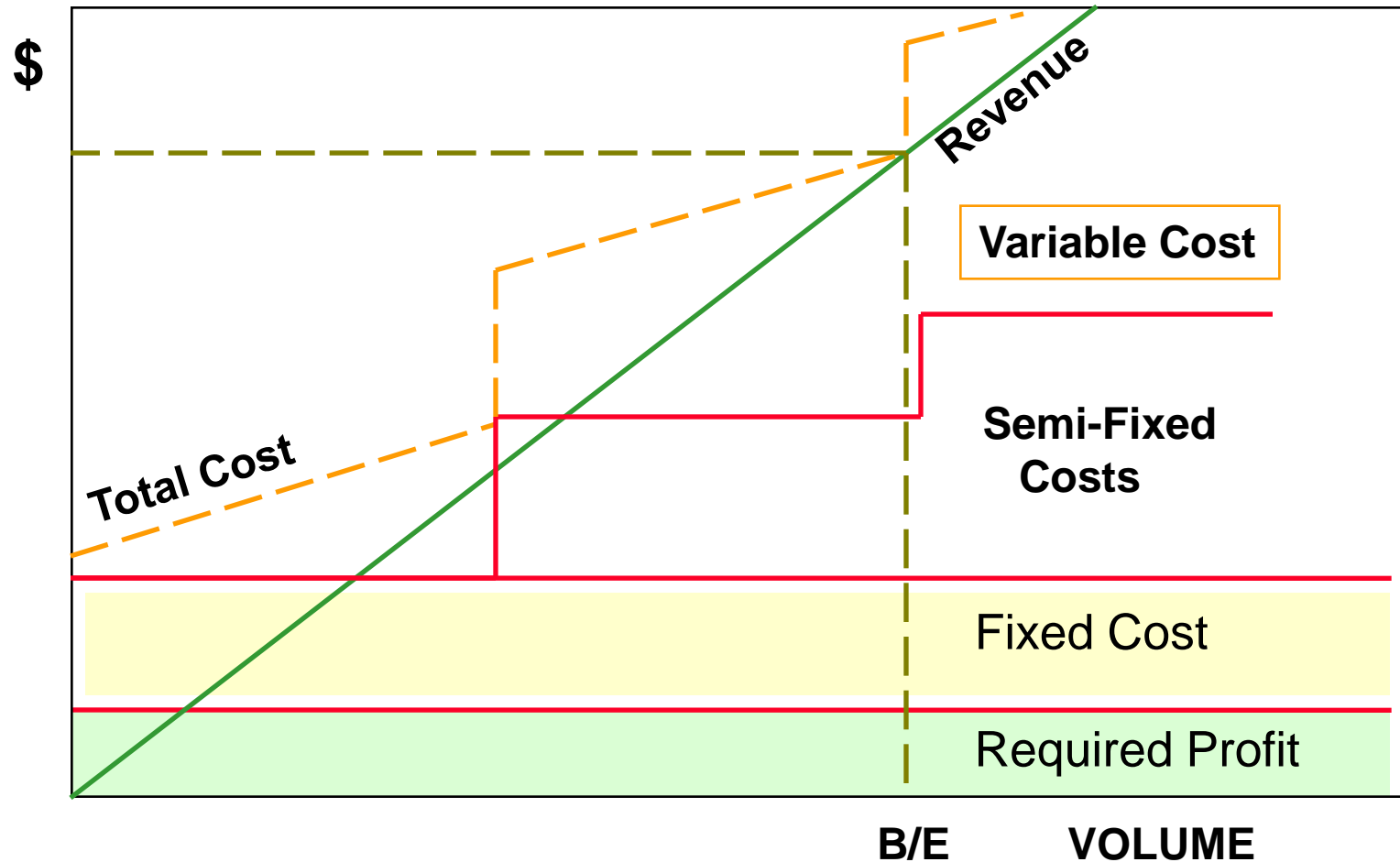
Complicators

- Semi-fixed costs

Break-even Analysis



Break-even Analysis



Reverse Income Statement

Complicators

- Semi-fixed costs
- Variable cost = f (volume)

*To the rescue: Excel's **Solver** functionality*

Reverse Income Statement

Complicators

- Semi-fixed costs
- Variable cost = f (volume)
- Questionable assumptions

Is the required sales level reasonable to expect ?

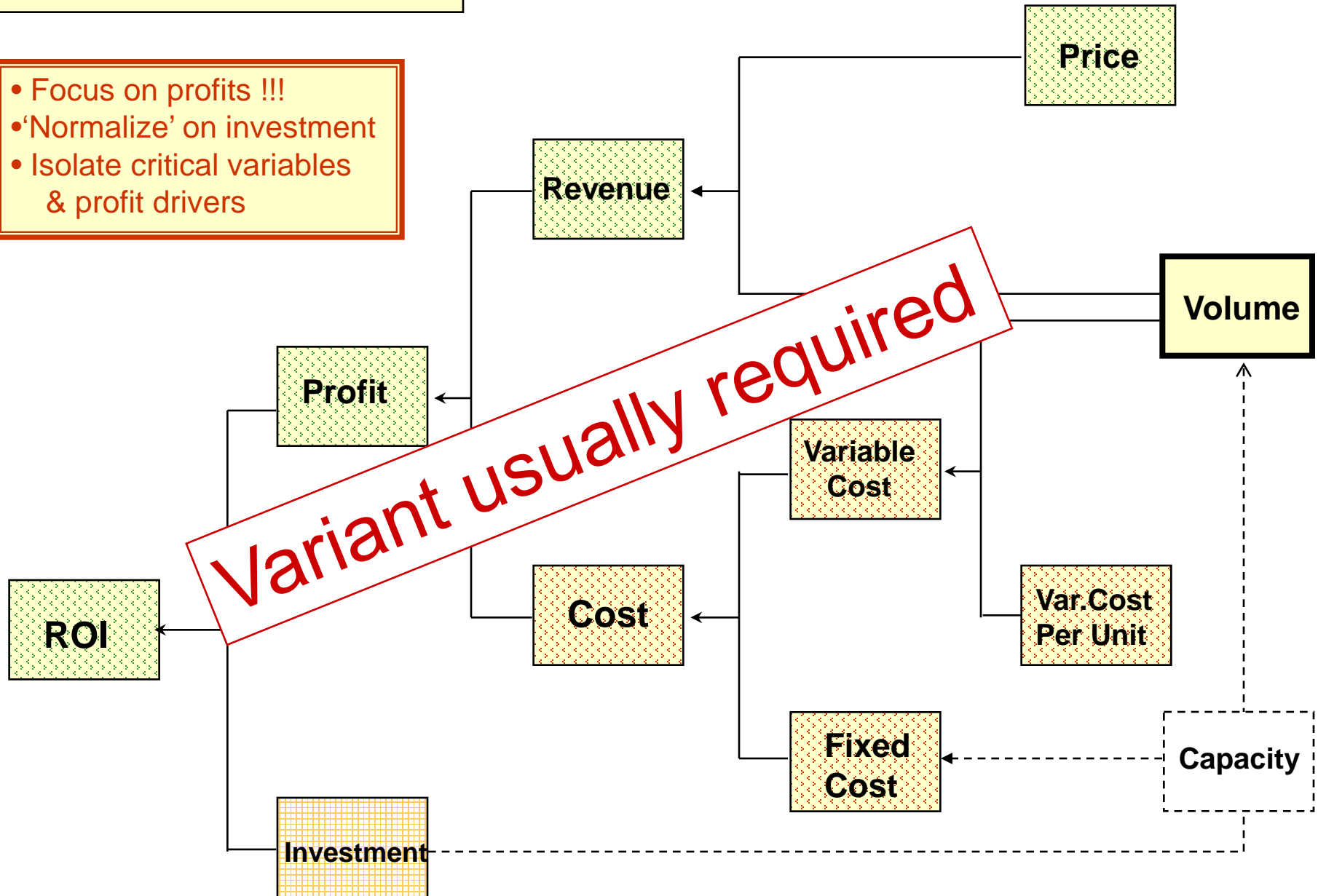
Discovery Driven Planning

The Process

- Specify required profitability
- Estimate major cost factors
- Determine required sales level
- Isolate key variables & assumptions

Return on Investment

- Focus on profits !!!
- 'Normalize' on investment
- Isolate critical variables & profit drivers



Variant usually required

Discovery Driven Planning

The Process

- Specify required profitability
- Estimate major cost factors
- Determine required sales level
- Isolate key variables & assumptions
- Periodically revise estimates and validate feasibility of projections

Key
Reverse
Income (*P&L*)
Statement

Important

Discovery Driven Planning

The Process

1. Specify required profitability
2. Estimate major cost factors
3. Determine required sales level
4. Isolate key variables & assumptions
5. Periodically revise estimates and validate feasibility of projections

Reverse Income Statement, Assumptions Checklist

Discovery Driven Planning

Summary

- Initially, little is known and much is assumed
- Assumptions (best-guess estimates) must be tested and questioned
- Assumptions are systematically transformed to knowledge, and ...
- The real potential of the venture is discovered as the knowledge unfolds