Discovery Driven Planning
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!
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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
• 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

ROI

Profit

Revenue

Cost

Variable Cost

Fixed Cost

Investment

Price

Volume

Capacity

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Discovery Driven Planning
The Process

• Specify required profitability
• Estimate major cost factors
• Determine required sales level
Breakeven Analysis

- Fixed Cost
- Variable Cost
- VOLUME

Required Profit

Revenue

Total Cost

B/E

Variable Cost

Fixed Cost

Required Profit

VOLUME
Discovery Driven Planning

The Process

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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.
• Expect investment = $1 million
• Set ROI hurdle @ 15%
• Implied profit hurdle = $150,000
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• 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
Breakeven Analysis

- **Fixed Cost**
- **Variable Cost**
- **VOLUME**

Break-even Analysis

- **Revenue**
- **Total Cost**

- **Variable Cost**
- **Fixed Cost**
- **Required Profit**

B/E

VOLUME
Breakeven Analysis

- **Semi-Fixed Costs**
- **Variable Cost**
- **Fixed Cost**
- **Required Profit**

The graph illustrates the relationship between revenue, total cost, and breakeven (B/E) point. It shows how the breakeven point is determined by the intersection of total cost and revenue lines.
Reverse Income Statement

Complicators

- Semi-fixed costs
- Variable cost = \( f (\text{volume}) \)

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
# Assumptions Checklist

<table>
<thead>
<tr>
<th>RIS Factor</th>
<th>Current Working Assumption</th>
<th>Values Range</th>
<th>Degree of Certainty</th>
<th>Results Impact</th>
<th>Planned Research &amp; Analysis</th>
<th>Person Resp.</th>
<th>Due Date</th>
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Return on Investment

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

Revenue

• Price
• Volume

Cost

• Variable Cost
• Var. Cost Per Unit
• Fixed Cost

Investment

ROI

Profit
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