2.009 Product Engineering Processes
2.009 Product engineering processes today

business case the (very) basics

hand it over. voluntarily please!
2.009 Product engineering processes
Sets
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Sets
RSVP update

you (students in class) do not need to RSVP

2 family/SO or 1 friend

use your email link for family guests or send invitations to others

e-mail 2009rsvp with special team guests (names, email address)

lotteries Friday, Monday and Wednesday
And now!
a mini quiz

please use the small index card

i) a _______ is a powerful tool for designing a presentation/narrative

ii) a consistent _______ layout structure helps to make slides coherent and understandable

iii) in the final presentations, slides will be _______ proportion
A proposition

I will give you $1000 today!

or

I will give you $1200 next year!

factors in making your decision?

- current financial/life circumstances
- trust in the monetary source
Concept 1
Time value of money

A dollar now is worth more to you than a dollar in the future.

Interest rate $r = \%$ per period $n$

Future value = present value $\times (1+r)^n$

$r = 10\%$
Concept 1
Discount rate

your personal, discount rate $r$ per period $n$ is ...

$(1+r)^n = \text{future value/present value}$

when you perceive present and future value to be equivalent

so, if you decided to:

take $1000$ from me now, your $r$ per year is $> 0.2$

wait for $1200$, your $r$ per year is $\leq 0.2$

personal discount rates tend to be high!
Concept 2
Net present value (NPV)

Future cash flows can be converted into a present day value using an appropriate discount rate

\[
NPV = \sum_{n=1}^{m} \frac{c_n}{(1+r)^n}
\]

- \(c_n\) is cash flow in period \(n\)
- \(r\) is discount rate per period \(n\)
- \(m\) is total number of periods (3-5 years typical)
Another proposition

please give me $1000 today

and I promise...

I will give you $1300 next year!

…at least I am quite sure that I will pay you but there is some chance that I might lose it and won’t pay you back at all.
Concept 3
Internal rate of return (IRR)
a.k.a. return on investment (ROI)

At what discount rate will future cash flows have the same NPV as your initial investment?

$$i = \sum_{n=1}^{m} \frac{c_n}{(1+r)^n}$$

- $i$ = investment
- $c_n$ is cash flow in period $n$
- $m$ is total number of periods
- $r$ is the IRR
If you gave me $1000 now expecting $1300 next year, an expected IRR of 30% was enough for you to invest

$$1000 = \frac{1300}{(1+r)^1}$$

If you did not give me $1000 now, an expected IRR of 30% was not enough
## Expectations

**IRRs and risk**

30+++\% for risky new ventures
20 \% for new products
15 \% for extensions/improvements to existing product
10 \% for cost improvement to existing product

**risk-free rate-of-return**

\sim 2-3\% for short term government bonds
Return expectations
Differ with type of investor

venture investment
strategic partner

angel investment
crowdfunding
question:
How to convince people to give you money?

answer:
Have a credible business proposal

What’s a proposal about?
value propositions
getting your product to users
Value proposition(s)

Part 1: product point-of-view

glow is the interactive yoga mat that allows users to practice yoga in their own home as if they were in a studio.

not a list of user needs!
what is your product?
who is your user?
how does the user benefit?
where and when would this product be used?
why would someone want this product?
Value proposition(s)
Part 2: business point-of-view

can you deliver?
your product’s value proposition
clear target market
know why purchasers will buy/adopt
know why purchasers will not buy – competition
a desirable return (monetary or otherwise)
your confidence, enthusiasm, and trustworthiness
Business Proposal

Important take away messages

product value proposition
We have a desirable, competitive product
what is the product
what are its unique benefits

business value proposition (we can deliver that product)
We have an attractive market
market size $, and 3-year growth rate
profitability and/or other killer benefits

We have a viable business
IRR xx% with initial investment of $ xx
break-even at units in xx months
reach steady state in yy months
Product Value Proposition

A competitive product value proposition

competition can be another product ... or simply old way of doing things.

killer attributes
attribute 2
attribute k
Business Proposal

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Business Value Proposition

Attractive market

target market

who will buy it and how they relate to product? (< 25 words)

market characteristics

where and how will it be bought: store, sales rep, etc?
how will buyers know about your product?
why is your price attractive?
Business Proposal

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Business Value Proposition
A viable business

Getting a handle on your return

but first
Determine your revenue, costs, expenses, and initial investment
Revenue

i) simplified sales estimation

Assume volume, \( Q_{009}^{\text{max}} = 180K \)

4 years to reach asymptote .... and

guestimate intermediate points
Revenue

ii) develop pricing strategy

price ≠ cost

ideally:
cost and price both decline, margin increases
Cost

A mini quiz!

What is the relationship between the cost of an alpha prototype and the product’s cost?

answer: there is no relationship
Revenue

ii) develop pricing strategy

price ≠ cost

ideally:
- cost and price both decline,
- margin increases

\[
\text{Revenue} \quad \text{cost} \quad \text{price}
\]

\[
\text{Revenue} \quad \text{price} \quad \text{cost}
\]

\[
\text{Revenue} \quad \text{price} \quad \text{cost}
\]
Revenue
Other possible sources

the value of goodwill?
strategic positioning?
Business Value Propositions

A viable business

Getting a handle on your return

but first

Determine your revenue, costs, expenses, and initial investment
# Revenue, Cost and Expenses

**Simplified profit and loss statement**

<table>
<thead>
<tr>
<th></th>
<th>$T_1$</th>
<th>$T_2$</th>
<th>...</th>
<th>$T_k$</th>
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<tbody>
<tr>
<td>sales revenues</td>
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<tr>
<td>materials cost</td>
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<tr>
<td>manufacturing cost</td>
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<tr>
<td><strong>gross profit</strong></td>
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<td>R&amp;D expense</td>
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<td>sales expense</td>
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<td>gen. admin. expense</td>
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<tr>
<td><strong>NEBT (net earnings before tax)</strong></td>
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<td>interest exp.</td>
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<td>taxes</td>
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<tr>
<td><strong>NEAT (net earnings after tax)</strong></td>
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</tbody>
</table>

- Price $ \times $ quantity
- $ \text{paid for parts}$
- $ \text{paid for labor, capital}$
- sales rev. - material cost - manufacturing cost
- $ \text{paid for engineers and equipment & stuff}$
- $ \text{paid for sales people, customer lunches, travel ...}$
- $ \text{paid for office, insurance}$
- gross profit - $\Sigma$ expenses

*should be monotonic increasing*

*better be monotonic increasing*

*use 4-year time horizon*
Costs and Expenses

Examples

Cost
materials, labor, overhead 69.7%

Expense SG&A
sales general and administrative 24.3%

Expense
R&D, interest, taxes 3.6%

Profit 2.4%
NEAT: net earnings or profit after taxes
# Revenue, Cost and Expenses

**Estimate based on ratios**

<table>
<thead>
<tr>
<th></th>
<th>$T_0%$</th>
<th>$T_1$ $$ $</th>
<th>$\ldots$</th>
<th>$\ldots$</th>
<th>$T_{k-1}$ $$ $</th>
<th>$T_k$ $$ $</th>
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</thead>
<tbody>
<tr>
<td>units sold</td>
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<td>a sales revenues</td>
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<td>b returns, etc.</td>
<td>$&lt;2%$</td>
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<td>c materials cost</td>
<td>$\approx17%$</td>
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<td>d manuf. cost</td>
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<td>e depreciation</td>
<td>$\approx5%$</td>
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<tr>
<td>f gross profit</td>
<td>$\approx60%$</td>
<td>$f=a-(b+c+d+e)$</td>
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<td>g R&amp;D</td>
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<td>j NEBT</td>
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<td>$j=f-(g+h+i)$</td>
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<td>k interest exp</td>
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<td>l taxes</td>
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<td>m NEAT</td>
<td>$\approx5%$</td>
<td>$m=j-(k+l)$</td>
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</tbody>
</table>
Revenue, Cost and Expenses
First order estimation heuristics

manufacturing cost = materials cost \(\text{(at volume)}\)

tax rate on earnings (NEBT) = 50\%
Business Value Proposition

A viable business

Getting a handle on your return

but first

Determine your revenue, costs, expenses, and initial investment
Business Value Proposition

Initial investment

Estimate a base-line for required investments

Target an initial break-even time, $T_b$ (first period in which profit $\geq 0$, 1-3 years)

<table>
<thead>
<tr>
<th></th>
<th>$T_1$</th>
<th>$T_2$</th>
<th>$\ldots$</th>
<th>$T_b$</th>
<th>$\ldots$</th>
<th>$T_{k-1}$</th>
<th>$T_k$</th>
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<tbody>
<tr>
<td>Cost+Expenses</td>
<td>$$</td>
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<td>SG&amp;A expenses</td>
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<tr>
<td>R&amp;D, interest, taxes</td>
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<tr>
<td>Total</td>
<td>$CE_0$</td>
<td>$CE_1$</td>
<td>$\ldots$</td>
<td>$CE_b$</td>
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</tbody>
</table>

Initial investment estimate: $I_0 = [CE_1]+[CE_2]+\ldots+[CE_b]$
Business Value Proposition
A viable business

Getting a handle on your return

but first
Determine your revenue, costs, expenses, and initial investment
Internal Rate of Return (IRR)

Solve for $r$, ~4 years out

\[ \frac{\text{CF}_1}{(1+R)^1} + \frac{\text{CF}_2}{(1+R)^2} + \cdots + \frac{\text{CF}_k}{(1+R)^k} - I_0 = 0 \]
Question!
How do you know when you have the right answer?

Answer:
Fiddle with sales, costs, expenses, investment until business looks reasonable

Or:
Fiddle until you have no belief that your business can credibly look reasonable
But wait...
What about crowdsourced fund raising?

raise directly from your potential customer base
nearly 50% of kickstarter projects get funded

**pros:** *just do it*
don’t need to fit the pattern of typical venture funding

**cons:**
don’t need to fit the pattern of typical venture funding

75% of hardware/design projects don’t complete on time
Business Proposal

Important take away messages

product value position
We have a desirable, competitive product
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business value position (we can deliver that product)
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reach steady state in yy months
But wait
There are different types of business proposals!

patent & license (company, NGO)
joint development
toll manufacture (provide materials/components for a fee)
contract manufacture (your label on product someone else makes)

patent & sell (for-profit or not-for-profit)
Developing a business case

Step-by-step

- Identify product value proposition
- Identify business value proposition
  - Create a development and sales timeline
  - Estimate cost to manufacture
  - Determine the path for product to reach customers

Think about how to communicate the business case!
Communicate your story in 2.009

ROI is analogous to a detailed design calculation—it’s not the business case!
a credible path for your product to reach its users!
is 10-15% of your presentation time

it’s a product launch, not a business pitch

if you don’t understand a question, don’t pretend to!

answer informatively and concisely
And finally

coming up...

Thursday 7 PM: Costing tutorial: assembly drawing

Thursday PM: 30 minute ID consultation

Friday class: Consulting lecture in Pappalado: product and presentation