

A STRATEGIC ANALYSIS OF A PRIVATE EQUITY FINANCIAL SERVICES FIRM

by

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1 PRODUCTS, MARKETS, OVERVIEW

1.1 Introduction

This strategic analysis examines Genesis Exchange, an Applications Service Provider (ASP) of private equity development and management services to early stage private companies and investors. The purpose of this paper is to evaluate the company's industry, identify key issues facing the firm and provide recommendations to address those issues.

1.2 The Company

Genesis Exchange Corp. (Genesis) operates an online, early-stage capital formation system modelled on the features of public stock markets, acting as a broker of private equity funding as well as a supplier of related services. The Exchange is a marketplace for private firms and investors, created to provide evolving companies with an alternative method for listing and ultimately issuing stock and trading the equity in their companies. It allows private companies to manage the complete investment cycle, including shareholders and new prospective investors, and also provides an arena to refine the skills of capital procurement, continuous disclosure and corporate governance. Unlike a brokerage exchange where buyers and sellers are different, Genesis is a "pure" exchange, where the price is established using competitive bids and asks, and the buyers and sellers can change positions. While Genesis has adopted existing market forms into the online environment, the functioning and relative use of different market mechanisms have been altered.

Genesis is "licensed" to operate its exchange in B.C. by virtue of an exemption order from the British Columbia Securities Commission (BCSC). Securities regulations require all

stock sales and trading to conform to public, securities markets regulations, unless they can prove that they are exempt from the regulations. Obtaining an exemption entails in part the blocking of the public from participating in the market and ensuring that the private investor is sophisticated enough to protect themselves.

1.3 Company History

Genesis Exchange is a start-up company, formed in 2003 by Glenn Ballman. Mr. Ballman started one of Canada's first online computer resellers in 1996, MegaDepot.com, and after unsuccessfully trying to raise money for the business in Western Canada, opened an office in Seattle in 1998. Within months he had raised several hundred thousand dollars in "angel" investment, followed by another \$11 million in venture capital. That financial injection allowed the company to adjust its target market and provide new product and service offerings, undergoing a re-branding and name change to Onvia.com. In 2000 it did another follow-on venture capital (VC) round, and then conducted an Initial Public Offering (IPO) on the NASDAQ stock exchange raising US\$244 million. As a public company, Onvia.com gave Glenn a whole new set of challenges until he finally lost control of the company and departed. Glenn then became an "angel" investor himself, providing financial, leadership and management support to numerous companies.

"Angel" investors (or "business angels") are defined as high net worth individuals, usually accredited investors who invest their own funds in private companies, typically at the seed or early stages. To most companies though, angel investors are much more: they often bring expertise or affinity for that company's products, markets or management team. Many serve as active advisors or mentors for entrepreneurs, provide additional relationships to aid the business' growth, and supply industry and entrepreneurial experience.¹ It is worth noting that many

¹ (Ewing Marion Kauffman Foundation, 2002, p. 2)

investors, including those who participate in the Genesis Exchange, do not consider or call themselves “angels”, rather they are financially well-off individuals, also termed as “informal investors”, who look to make private investments in businesses. (The label “angel” was the term used historically for investors who backed new plays on Broadway.)

Through this experience, Glenn realized that there was no single, organized management system for early stage private investment. As a CEO he had experienced the difficulties of a young, private company trying to find the right investors and closing financing deals. He had seen aspects of the public stock market that private companies could greatly benefit from, such as the corporate governance discipline that is imposed upon them. Likewise, as an angel investor, he discovered the high risk and poor visibility that investors have into issuing companies, and saw the lack of discipline and reporting by private issuers. These markets are typically characterized by information asymmetry, since private companies have a strong propensity to keep their information confidential. In many cases, investors do not receive as much information as they would like.

Further, Glenn witnessed private companies going public for the wrong reasons, including wanting access to unsophisticated capital and a departure from the company. He realized that what the early stage private equity market needed was a proper system and marketplace—an exchange. This would allow both parties to better achieve their objectives of generating liquidity (the ability to convert shares to cash quickly) through higher access to capital, and a resulting improved return on investment.

After undergoing two years of programming and development, the Genesis Exchange was launched for customers in late 2004. Currently Genesis has offices in Vancouver, BC and Charlotte, North Carolina and a total staff of eight. Besides Genesis Exchange, Mr. Ballman owns a Vancouver-based contract web development company, which has provided office space, part-

time staffing resources and funding to Genesis Exchange. The company plans to carefully and strategically expand its service to other Canadian jurisdictions and eventually to the USA.

1.4 Markets

Genesis Exchange's potential market can be broadly described as the equity financing market between private investors and non-public companies. This financing is also referred to as "risk capital", because it is totally unsecured. The Exemption Order granted by the BC Securities Commission and other future commissions specifically excludes any public investors in the Exchange, otherwise the companies trading on the exchange would have to be compliant with all regulations and laws governing public companies, thereby negating the advantages of keeping the company private. Genesis' addressable market is Small and Medium sized Enterprises² (SMEs) that require equity financing in amounts generally not exceeding \$10 Million. Within this customer set, Genesis is targeting small, high-growth Canadian companies that are at the seed, start-up or early stages. A high-growth firm is one whose revenues have grown by more than 50 percent over a consecutive three-year period.³

Generally these firms are involved in knowledge-based industries, such as the health sciences, biotechnology, communications and computers sectors. These firms hold fewer hard collateral assets like inventories, which restricts their ability to finance with debt. In fact many firms are still developing their products or services, making debt a poor financing alternative because they do not have the revenues to make interest payments.

Whereas the demographics above describe the firms in Genesis' market, psychographic factors help characterize the real customer behind these businesses—the owners. The profile of a typical target business owner is a driven entrepreneur—independent, self-confident, disciplined

² Canadian definitions of a small business vary between 1 to 50 and 1 to 99 employees, and medium sized businesses arguably range between 51 to 250 and 100 to 500 staff.

³ (Industry Canada, 2003, p. 4)

and hard working. Noted American Psychologist David McClelland identified three types of motivational needs found in the workplace: the need for affiliation, power and achievement.⁴ Entrepreneurs, especially the successful ones that get equity financing, are usually dominant in the last, deriving high satisfaction in attaining challenging goals and accomplishing things not done before. Another characteristic of these business owners that also attracts investors is having an eye for opportunity—finding a need and quickly satisfying it. However these traits can also create a hurdle to obtaining equity financing, as these fiercely independent owners sometimes have difficulty in relinquishing control and ownership of their businesses.

There are three distinct Exchange participants within these markets. The primary customers are the private companies, also referred to as issuers, since they use the Exchange to issue and manage their stock shares. The core services discussed below are primarily aimed at this group.

Investors are the second set of customers, and they enter the Exchange in two ways. First as shareholders of the private companies that join the Exchange, because one of the first tasks that the companies perform is the setting up of their capitalization structure in Genesis. A majority of these shareholders are friends or family, company employees or business associates. They are sometimes referred to as “love money”, since they “tend to base their decisions on the nature of their relationship with the investee, and pay less attention to the nature of the deal or the potential risk”.⁵

Alternatively, external investors join the Exchange seeking additional investment opportunities. Often angels, these investors are typically “accredited” investors, a term used by security commissions to define investors that are financially sophisticated and have no need for the protection provided by government regulations, such as those that govern public markets. In

⁴ (McClelland, 1988)

⁵ (Industry Canada, 2004, p. 130)

terms of demographics of this important Exchange participant, approximately 90 percent of angel investors are either current business owners or have owned a business previously.⁶ More than two thirds of angels invest in companies within 50km of their home, 98 percent are male, and they typically invest between \$50,000 and \$250,000.

The third type of participant is termed a 'Service Provider', and while important to the business model, is not considered a customer. These are firms that provide complementary professional services to both companies and investors, such as legal, risk management, accounting, investment relations, and other advisory services. Service providers can use the Exchange to lower their costs of servicing their customers, for instance by using the electronic tools to perform work for their customers. Additionally they can find new customers by promoting themselves to issuers in need of their services.

1.5 Market Environment

There have been notable changes occurring in private equity markets in the last few years. Following the high technology boom and bust of 2000, the flow of equity funding to SMEs was restricted, especially to start-ups, as investors such as venture capital firms became more conservative in their lending guidelines in order to avoid a repeat of their losses. Although last year marked the first year-over-year increase in venture industry capital invested in Canada since 2000, investment levels are still less than a third the amount invested in 2000. Moreover, the number of firms receiving VC investment continues to drop.⁷

This decline in Canadian venture capital investment has occurred at the disproportionate expense of SMEs. Large venture funds have grown in overall and preferred-deal size.⁸ Post-2000,

⁶ (Ibid. p. 10)

⁷ (MacDonald and Associates, 2005, p. 2)

⁸ (Industry Canada, 2003, p. 53)

VCs re-balanced their portfolios towards larger deals in firms with proven track records in more stable or promising sectors.

The economics of venture capital funds do not support the needs of the emerging growth company that requires investment in the \$100,000 to \$500,000 range. Even the most agile venture fund finds it difficult to serve the needs of small investee companies when it has to deploy capital in blocks of \$2 million or higher in order to leverage partner time and portfolio risk appropriately.

Characteristics of the Canadian marketplace have also acted as significant impediments to growth in private equity financing. There is an “absence of a well-developed marketplace for ‘love money’ and the angel investor category that tends to play an earlier role than venture capital in financing young, risky and innovative start-ups. This is due to tax policies, a shortage of willing high net-worth individuals compared to the United States and the lack of a coordinated educational approach to opportunities as angel investors. As well, there is a lack of coordination between provincial securities regulators ... (which) impacts overall capital markets by creating barriers to publicly listing which in turn act as barriers to venture capital exit strategies”.⁹ However, according to an Industry Canada commissioned survey in 2001, lack of preparedness by SMEs for investment is actually the leading factor inhibiting investment in Canada, edging out taxation and regulation”.¹⁰

Nevertheless there has been growth in the number of organized, formal business angel groups. This is in response to several factors including a desire to attract better deals and generate higher returns than angels acting alone; a widening “capital gap” between individual and institutional venture capital investors that has created a need and an opportunity for pooled investments; and the legal and economic complexity of these investments.¹¹

⁹ (CFIB, CME and RBC, 2002, p. 25)

¹⁰ (Equinox Management Consultants Ltd., 2001, p. 42)

¹¹ (Ewing Marion Kauffman Foundation, 2002, p. 1)

Another notable change in the market has come from the increased regulation in public markets, stemming from the various fraud and accounting scandals in recent years. The effect of new regulations like the US Sarbanes-Oxley Act drives up the cost of operating a public company and therefore may increase the likelihood that private companies will seek to stay private. Increased regulations are also raising investors' expectations for increased corporate governance, continuous disclosure and overall visibility into their investments, and this is trickling down into private markets. Even angel investors are becoming more sophisticated as buyers. Not only are they demanding better reporting and information from their investments, but also as noted above they are organizing themselves to improve their success through networking and education.

As well there has been continued growth in the number of companies in knowledge-based industries, fuelling increased demand for private equity.

These changes in the market environment have contributed to a gap between supply and demand in early stage capital financing for SMEs. Demand has grown but supply has not kept pace. This has created a growth in the need for the core services that Genesis Exchange provides to both issuers and investors.

1.6 Products and Services Offered

For clarity in this analysis, products are defined as the various financing instruments available to private companies, and services are the complementary functions and services employed to deliver and manage the financing. The Genesis Exchange online system provides four unique core services for private companies that enable the delivery of private equity product. In the order that generally parallels an issuer's typical chronological growth path, they are:

1. An information repository,
2. Capital management tools,
3. A primary offering platform,

4. An exempt-status capital trading system.

At its simplest, the Genesis system is a place to create and store all of a company's governance and fund raising information, including corporate records and filings, financials, business plans and board minutes. This begins to create a discipline of good corporate governance, which is a requisite to attract quality investors. The Exchange provides a complete electronic "binder" for due diligence materials—information that companies should have in place when courting potential investors—as well as an electronic document and image vault for secure storage. The system has a hierarchical navigation system of over 150 folders in which to organize and store this information. This service helps companies raise money because it helps address two problems discussed above: the information asymmetry issues for the potential investors, and the investee's lack of preparedness problem identified in Industry Canada's research.

While a company can use the Exchange just for this globally accessible storage system, the next set of services begins to put the information to use. Most importantly, the company decides how much information to disclose, and control who sees what. As well, automated communications ensure that companies follow continuous disclosure policies. Any changes that occur within the company that materially affect a shareholder, for instance a new share issuance, trigger automatic disclosure by the company to its shareholders through the closed-loop messaging system. The shareholder communication system is unique in that it simultaneously enables direct, complete and inexpensive shareholder contact, information disclosure, voting and messaging.

The system requires all participants in the Exchange to conform to securities regulations. Although many private companies do not know it, all companies—private or public—who offer or trade shares in their firms are governed by securities regulations. The Genesis system enforces compliance in a way that creates world-class disclosure and governance practices, but maintains

corporate privacy and growth objectives. Some of the patents pending provide a series of incrementally building governance requirements.

The above services allow a company to attain a listing on the Exchange. The next logical step most customers take is to conduct a share offering, since they usually join the Exchange for the express purpose of raising money. The system allows the company to float the offering out to its choice of potential investors, from its existing shareholders to other investors already registered in the system, or to external parties. The offering process revolves around an automated order book that orchestrates all the details of how the company wishes to conduct the offering. The system allows the company or its professional advisors to manage the entire bidding process, employing different pricing mechanisms and updating of prices dynamically as described in further detail below. Since the Exchange can provide more prospective “customers” for the issuer, in keeping with the laws of supply and demand, logically the valuation (price) of the offering may also be higher than outside of the Exchange.

The ultimate goal for most participants in the Exchange is to obtain liquidity in their non-public shares, which is extremely difficult to accomplish outside of public markets. Liquidity can be further defined as the degree to which an asset or security can be bought or sold in the market without affecting its price; consequently it is characterized by a high level of trading activity.¹² Public stock markets are among the most efficient examples of liquidity generated through trading. Genesis plans to launch a secondary trading exchange in 2006, which will not only allow all shareholders a vastly improved ability to trade their shares, but because the system provides improved visibility into the company and its value, share prices should tend to be higher than they would otherwise. The Genesis secondary trading system would operate similar to online stock brokerages, where orders are placed according to the conditions set by the seller, and buyers can enter bids. The trading engine would match the orders and bids and complete the transaction

¹² (Investopedia.com, 2005)

online, including settlement of accounts, all pursuant to rules adhering to Provincial Security Commission methodologies.

Liquidity is valuable for the company founders, but especially important for investors. While the founders and early management want an opportunity for departure, investors want to obtain a return on their investment in a forecasted time period. Without it, many will not invest. Short of selling the enterprise or taking it public, if a company is even at a stage where these options are feasible, existing investments are locked in and new investment can be locked out. Liquidity helps reinvigorate the capital structure with new people, new ideas as well as providing the commensurate rewards sought after by stakeholders.

These core service offerings are wrapped by additional services, such as seminars (e.g. how to prepare your company for a successful financing), educational materials, and listing features such as front-page advertising and enhanced listings. The four core services are mainly targeted at Genesis Exchange's primary customer: the capital-seeking issuer. However, the Exchange is a marketplace, where service providers such as accounting, legal, and PR firms can not only consult to market participants, but also directly provide services through electronic exchange features like capitalization table verification and primary offerings. Accordingly, service providers also use many of these features on behalf of their clients. As well, there are additional services that cater to the investors and service providers, including shareholder investment portfolio management tools and customized reports.

These entire services are meant to provide the following high-level benefits for issuing companies and/or shareholders:

- Higher access to capital with resulting better valuations;
- Liquidity or diversification for early shareholders or founders;
- Fast, predictable and more controlled capital formation and governance;
- Reduced capital management costs.

These services are very differentiated from anything else in the market. The current primary competitors to the Genesis Exchange in Canada are the existing channels that private companies have—law and accounting firms, other professional and consulting companies and various accredited investor deal boards, which are typically sponsored or run by business associations, entrepreneurs, or angel networks. These types of firms are the “Service Providers” referred to above, and Genesis hopes to attract many of them to participate in the Exchange. However, given the sheer size of this marketplace it is unlikely that the majority of these firms will use Genesis to leverage their business, and instead will compete with it.

The first three of Genesis’ four core services can be purchased from a variety of these competitors. For example, law firms offer many of the services that Genesis Exchange does. They store and maintain their customers’ legal information such as central shareholder registries, financing documents, investment filings, board minutes and resolutions. Most lawyers do not provide their clients with “tools” to manage their capital structures and shareholders as Genesis does, instead they perform these functions on their behalf—they are the tools for their clients. Law firms and investment dealers are examples of competitors that will assist their client to conduct a primary offering of shares from the company’s treasury, whether for common stock or preferred, warrants or options.

Genesis Exchange anticipates however that its secondary trading stock exchange will be more difficult for its competitors to duplicate. While not yet operational, if it successfully attracts enough participants and sufficient supply and demand of equity, and can begin to achieve network effects, it could offer liquidity in private stock trading that currently does not exist.

While the “what” of much of Genesis Exchange’s services may be similar to its competitors, Genesis differs greatly in the “how” and the “where” these services are delivered. To begin with, the whole Exchange is online. All the information including images and documents

are digitized and stored in Genesis' secure servers. (The customer can execute a resolution to convert its primary mode of stock management from paper to digital.) This allows not only Genesis' customers to access the information when and where it chooses, but also its customers' suppliers (e.g. the law firms) and its customers' customers, i.e. prospective investors.

Genesis has automated all the services so that volumes of paper that often fill scores of file cabinets are no longer necessary to do most of the tasks. For instance, to conduct an offering on Genesis, the issuer (or their designate service provider) can create all facets of an offering. The issuer specifies the method of price and volume determination, the stock rights and privileges such as conversion rights, anti-dilution protection measures and dividend and liquidation preferences, as well as redemption and protective provisions. An electronic order book provides complete management of the offering while out on the market floor and allows the issuer to manage the investor pipeline and bidding, publish and manage documents required through the process, and control the share allocation.

Differences between Genesis Exchange and its competitors are perhaps most apparent with the pricing of the services. Genesis makes the majority of its money by charging fees to the issuing companies. For the repository and tools, Genesis charges a monthly subscription fee ranging from \$24.95 to \$249.95, which varies depending on the services bundled with each membership level and the number of shareholders the issuer has. For these lower level services, Genesis' competitors typically charge high flat or hourly fees every time they touch a client. To conduct an offering, Genesis charges fees for various stages of the process. Creating the offering itself costs \$1000 on average. Publishing the offer to the market floor where all accredited investors can see it is \$400 per month, and the weighted average expected value of fees for a successful closing, which are tiered based on the amount raised, yield approximately \$3600 per offering. Securities regulations require Genesis to charge fixed fees (for example a "per share" transaction fee), instead of a percentage of funds raised, so that it does not operate like an

underwriter and lose its exempt market status. Fees are charged to investors and service providers depending on the adoption of some value-added services, however they have a small impact on the company's bottom line.

Prices were determined primarily by examining their worth to the customer. Feedback was obtained from customers who had done funding rounds and those who had not, and the founder's own experiences of raising angel, VC and public financing were also factored in. research of prospective customers indicated that they believe paying between 1% and 2% of capital raised would be very good value. For most of Genesis Exchange's customers, the services are not merely a 'want'; they are a necessity. In many cases issuing companies have less than a year's worth of funding in the bank, and raising money is an all too frequent occurrence. The cost of raising money the traditional way (e.g. using a law firm), runs at minimum into the multiple tens of thousands of dollars and between 7% and 10% of capital raised. Company executives must invariably travel, prepare marketing and due diligence materials, and of course engage the professional services firms at expensive rates to provide what in many cases is manual work done by a legal assistant. The issuers also incur opportunity costs because this responsibility usually falls to the CEO, which can be a distraction from focusing on growing the business. By comparison, an automated system with its own supply of accredited investors that can raise funds at a cost of approximately \$5,000 (not including some minimal additional services that their legal counsel will need to provide) is an attractive alternative.

Revenue streams for Genesis Exchange's operations will come from four main areas. Membership fees from the three different participants will average 5-10% of Genesis' total revenue, with the greatest part coming from the issuers. Fees from enhanced services will be less than 5% of total revenue. The remaining and vast majority of revenue in the near to mid term will be derived from primary issuance management - the making of the market for the sales to initial angels and friends and family. This will be augmented by trading transaction revenue when the

secondary market capital trading system is operational late next year. Overall revenue is anticipated to rise significantly when Genesis begins to build a critical mass of issuers and investors after several years.

New economy products and services are often characterized by high fixed and sunk costs and low marginal costs; costs of creation are high relative to costs of reproduction.¹³ This generally applies to Genesis Exchange, whose fixed costs are concentrated in technology—specifically computer hardware and software product development. While some of these costs will be capitalized, the majority supports the offerings and trading systems. Genesis' heavy reliance on technology lowers its marginal cost of providing services to customers. The main variable costs will be for staffing as well as sales and marketing. Offerings consume a disproportionate share of the staff costs as a percentage of revenue, since customer support needs are higher with this more complex service. The secondary stock trading service is forecast to have the highest profitability, supplying more contribution margin due to the spread between its price and lower variable costs. As well, it can capitalize the most on scale effects, obtaining favourable operating leverage by spreading its fixed costs over an expected increasingly higher volume of trades.

Genesis Exchange's current market share is negligible, since it only "opened for business" at the end of 2004. Assuming a Canada-wide \$5 billion annual market for total informal/angel primary investment (see discussion of industry size below), a 2% market share would mean \$100 million in private placement (offerings) activity each year. Genesis' vision is to achieve a minimum 5% market share within two years of serving the whole Canadian market. This is almost entirely an offline market today, so Genesis anticipates a 5% share of the total industry would equate to 90% or greater of the online market. In terms of secondary trading, there is no true established electronic marketplace for private securities in Canada. Consequently the

¹³ (Shapiro, 2003, p. 26)

founder anticipates that Genesis could attain a market share of 50% or greater within two years of serving the Canadian market.

In order to begin building this forecast market share, Genesis plans to use “push” marketing tactics, which will help it conserve its capital. However, the company is early stage and so it has not yet built up the volume of participants and activity that would create a network effect draw. Although a considerable portion of Genesis’ small business customers have very tight cash flows, it expects that its low initial pricing (in relation to the marketplace) will help foster an “I’ve got nothing to lose” attitude from new issuer customers, and plans to charge fees for primary share offerings that average out to approximately 1% of capital raised, factored into a transaction price. Within one to two years it plans to raise this to 2% of capital raised.

2 INDUSTRY ANALYSIS

The private equity industry in Canada can be defined in several ways. From an addressable market perspective, SMEs comprise 99.7% of the one million employer businesses in Canada.¹⁴ More specifically, identified by business stage, the broad target market of private equity financing candidates may be as many as 180,000 Canadian businesses, based on work by the Université du Québec à Trois-Rivières, which estimates that 13% of the 1 million SMEs are fast-growth firms and mutually exclusive from 5% which are seed/start-up firms.¹⁵ However the market is reduced further because currently only about 25,000 SMEs on average actually request risk capital each year¹⁶, a majority of which are within Genesis' target market. Of course, Genesis hopes that by providing improved access, it can increase the number of businesses that seek—and receive—this financing.

From a total dollar volume perspective, the size of Canadian private equity is massive. The entire professionally managed Canadian private equity funds universe was estimated at \$53 billion under management in 2003.¹⁷ This was made up of \$22 billion each in venture capital and buyout pools and \$4 billion invested by the mezzanine industry (the latter are two specialized forms of private equity funds, characterized chiefly by investment in established firms that are fundamentally changing their operations or strategies, or by the use of subordinated debt in conjunction with equity).¹⁸ The remaining \$5 billion is under management in miscellaneous private equity funds.

¹⁴ (Statistics Canada, 2002, p. 58)

¹⁵ (Research Institute for SMEs, 2002, p.59)

¹⁶ (Statistics Canada, 2000, p. 39)

¹⁷ (Goodman and Carr LLP-McKinsey & Company, 2004, p. 1)

¹⁸ (Industry Canada, 2003, p. 217, 221)

By contrast, estimates of angel investments alone vary widely between \$1 billion and \$20 billion *annually*—with approximately 60% of this going to SMEs¹⁹—compared to a little under \$2 billion in annual venture capital placements. A common characteristic of angel investors is that they prefer to remain anonymous, which makes it difficult to quantify their contributions. However, even using some market analyst’s assessments of a \$3-5 billion market, clearly angel investment outpaces venture capital.

2.1 Competitors

The four primary features of Genesis Exchange provide parameters for defining not only the market, but also the competition. Competitors are organizations that perform one or more of the following functions for capital-seeking private companies:

- Storage and management of corporate shareholding information;
- Company preparation for financing;
- Capital raising;
- Facilitation of share trading.

The primary competitors to date operate in the traditional offline channels and are mainly comprised of: law and accounting firms, investment dealers, angel investor networks, some venture capital firms, independent consultants, as well as various accredited investor deal boards which are typically sponsored or run by VCs, business associations, angels, or private investment networks.

Of the above types of companies, law firms are the chief competitors, in part because legal services are necessary throughout the whole process of financing. Law firms can provide a broad range of services at all stages of private equity investment cycle. This includes acting as counsel in the initial formation, structuring and capitalization, as well as advising on issues typically arising in relation to their ongoing management. Larger practices can encompass all forms of

¹⁹ (Equinox Management Consultants Ltd., 2000, p. 19)

transaction-oriented investment activity on behalf of their clients, including the making of initial investments (whether by way of equity or debt) and follow-on investments, the restructuring and/or protection of those investments where required, and a range of exit transactions executed through both the private and public markets. High profile law firms in the BC private equities market include Catalyst Corporate Law, Fasken Martineau and McCarthy Tetrault, however the latter two firms are examples of how as the firms get bigger, the less they tend to compete with Genesis because they focus more on larger investment deals and serving professional and VC funds. As a result, Genesis tends to compete with smaller, less rivalrous firms.

The same rivalry scenario tends to apply to many of the competitor types. Canaccord Capital is a major player in corporate financings, handling marketing and distribution of private placements and special warrants. Likewise, Ernst & Young and other accounting firms offer corporate financing advisory services including structuring, valuation and terms and conditions. While they could be classed as primary competitors of Genesis Exchange, they prefer to concentrate on deal sizes that start at the top end of Genesis' range.

Specifically in BC, other potentially key competitors include the Angel Forum, which provides investee education and investee-investor matchmaking services, and some of the western VCs that play in the lower, early stage end of the market, such as Ventures West and Greenstone Venture Partners.

It is important to note that Genesis competes with the firms discussed above in a very non-traditional way, to such a degree that arguably a truly direct competitor can only be another firm that combines the majority of Genesis' services and also delivers them online. While there is currently no online firm that is identical to Genesis, there are several business models that can be considered current or future competitors.

Conceivably an existing public stock exchange like the Canadian Venture Exchange could set up a private market and leverage their software, expertise and company contacts. However whereas the secondary market is all that these exchanges can offer, Genesis business model

focuses heavily on making the market for primary capital issuance. The Canadian Angel Investment Network is a web based portal and matching service of angel investors seeking investments, with entrepreneurs seeking capital, created to help Canadian angel investors invest in things that are more tangible, predictable and closer to home. Although it is only performing a matchmaking service for which it charges fees from entrepreneurs and investors, it potentially could expand its services in the future.

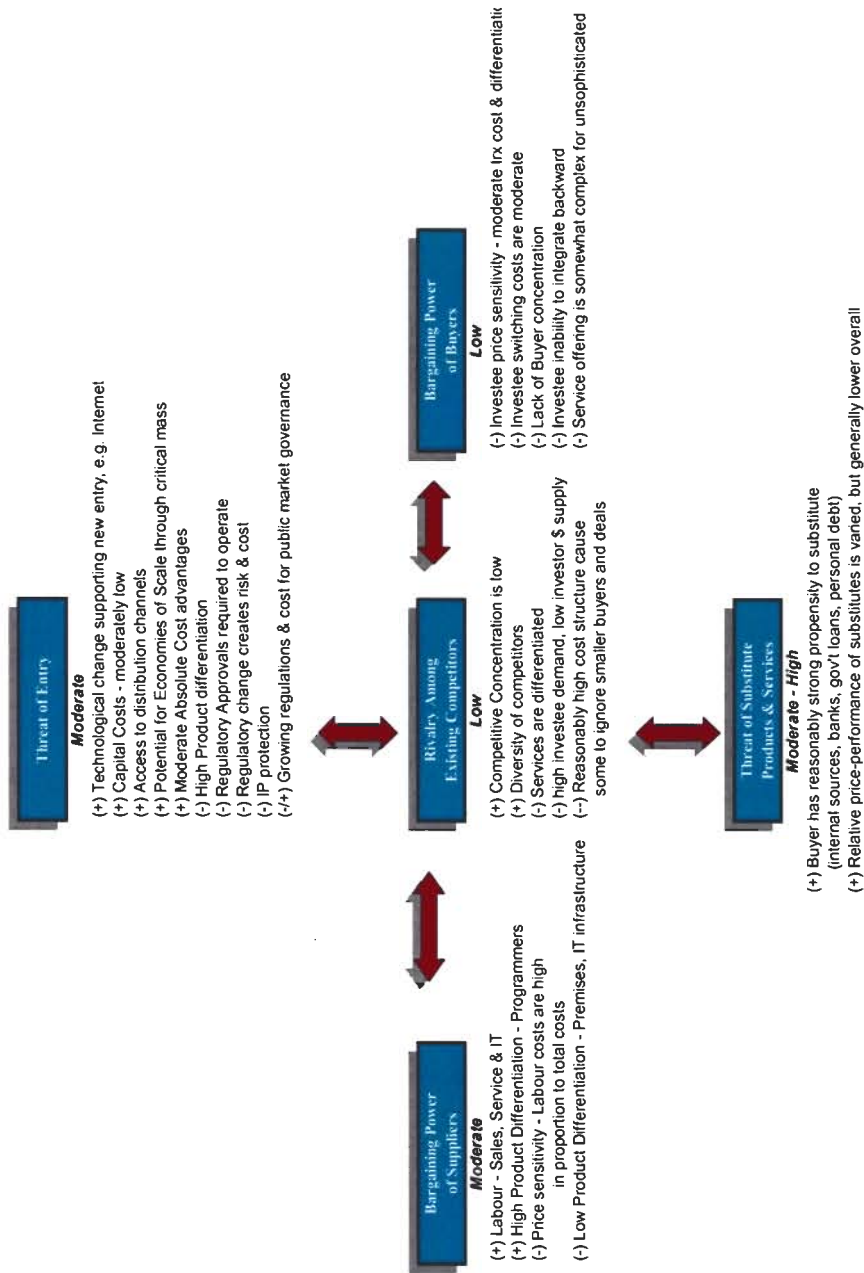
There are also at least two US-based online firms that can be considered competitors. The most likely is Entrex, which claims to have created an online marketplace to find, research, track, manage and trade interests in private companies—similar to Genesis Exchange’s four primary functions. Their marketplace will help to facilitate primary and secondary offerings pursuant to rules adhering to SEC methodologies for the private companies. Unlike Genesis—which is building its own exchange systems—Entrex is partnered with a brokerage firm and allows its clients to trade across existing Alternative Trading Systems, Electronic Communication Networks or Self Regulatory Organizations (exchanges) from around the world.

The other US-based firm is the New York Private Placement Exchange (NYPPE), a private transfer agent that operates primarily in the secondary trading of private equity securities. A well-connected Wall Street firm, over the last four years it has acquired firms that raised private and venture capital online. Although it currently operates in the yet-to-be launched “end” stage of Genesis’ business plan, it could conceivably move upstream of its current position without much difficulty.

2.2 Forces of Competition

This industry analysis uses Michael Porter’s “Five Forces of Competition” model; the structural determinants and their affect on the forces are shown in Figure 1 below.

Figure 1: Five Forces of Competition in SME Private Capital Market



Source: Bukszar, 2005 based on Porter, 1979

2.3 Rivalry Among Existing Competitors

Rivalry amongst competitors in this industry is 'low to moderate'. "When a market is dominated by a small group of...companies, price competition may also be restrained, either by outright collusion, or more commonly through 'parallelism' of pricing decisions."²⁰ This is not the case in the private equities industry, which is characterized by many firms spread around the country, making price coordination difficult and unlikely. For instance, at the lower end of the scale there are specialized lawyers and many small groups of Angel investors, while at the higher end there are large accounting and legal firms. Not only is the concentration low, but also as the previous section demonstrates, the participants are quite diverse, varying greatly in size and type. The more similar firms in an industry are, e.g. in terms of origins, objectives, costs and strategies, the more likely they are to avoid price competition,²¹ but again, this is not the case here. Both of these concentration and diversity factors play a role in increasing competitive behaviour, and so are shown with a positive (+) sign.

However as illustrated above, this diversity also contributes to a broad differentiation in services. Some angel investors only provide capital, and many independent consultants only help companies prepare for financing. On the other end of the spectrum, some competitors provide extensive services. For instance, upon investment, some angels and their networks provide very intense, niche services to the firm such as hands-on assistance, customized business advice and contacts, and market intelligence. Some investment dealers and full-service law firms provide all four of the primary functions noted previously, plus many ancillary services such as general legal and accounting advice. Where services are highly differentiated, price competition tends to be

²⁰ (Grant, 1987, p. 61)

²¹ (Ibid. p. 62)

weaker, even though there may be many firms competing, and hence the (-) rating for differentiated services.

Additionally, with the experiences of the recent tech boom and bust period, those with the capital available for investment have become extremely selective and cautious in making investments. As a result, there are many investees competing for the restricted supply of capital of fewer investors. The market is currently underserved and potential for growth exists. Demand is high, but supply is low.

Finally, some of these firms, particularly many of the law and accounting firms, investment dealers and VC funds (as noted earlier), have significant cost structures, especially relative to those of Genesis Exchange. Their higher costs make it too expensive for them to service the lower end of the capital market, i.e. deals under several million dollars. As a result, competition is lessened for market participants like Genesis, boutique law firms and angel investor networks. This factor is so strong that it is represented by a double negative sign (--), and lowers the overall competitive assessment for competitor rivalry to 'low'. This assessment aligns with the reality in the Canadian marketplace, where competition for "small cap" equity business is not great, and market participants focus more on avoiding risk, and finding and working with clients who have viable businesses.

2.4 Threat of Entry

If one thinks about the existing industry based on the functional and demographic definitions of the market given earlier, entry into the market for any of Genesis' primary functional areas is not difficult. Consequently the threat of entry for this industry has been characterized as 'moderate' at least at this time. By example, an existing law firm or consultant can contract to provide services to a small emerging company to help it raise and manage capital. While an examination of the structural determinants provides further detail of the underlying

factors, this analysis will emphasize the threat of other online models, which are the most direct form of competition to Genesis.

Technology reduces barriers to entry by other firms in multiple ways, particularly in the technology-intensive equities exchange or marketplace business. It provides a non-proprietary infrastructure that any person or firm can acquire with modest financial resources. Using Genesis Exchange as an example, it uses hardware and software development tools and Internet connections that are now essentially ubiquitous. Certainly Genesis's model would not even be possible without the advent of the Internet. The Internet especially benefits existing competitors by enabling reconfiguration of processes constrained by high costs of communicating, gathering information or completing transactions,²² which is particularly relevant to the financial services market.

Of course having the basic technology itself does not provide competitive advantage. It is what a firm does with it—enabling new business practices for example—that creates the advantage. Genesis' team has spent several years building and deploying exchange and gaming technology and is using that knowledge to build its exchange. An entrant that possessed the same basic technology would also need the relevant knowledge. Therefore an entrant that poses a more immediate threat is one that already owns exchange software. One such example—albeit in a different industry—is the Hollywood Stock Exchange, which uses exchange technology to operate a virtual stock market for entertainment personalities and products. EBay is another firm that possesses assets, knowledge and experience that could conceivably be leveraged into a private securities exchange. Not only do its technical systems—such as its robust transaction engine—have similarities to an exchange, but also it understands buy and sell behaviour extremely well, has experience with B2B transactions and a well-developed payment system (Paypal).

²² (Porter, 2001, p. 4)

Another impact that technology has is on cost. Information technology (IT) is increasingly less expensive and enables participants to get into the business—at least at an entry level—with low capital costs. It can reduce or eliminate the need for functions like sales forces and assets such as multiple or large physical locations. Accordingly, the technology factor and the capital cost factor are rated (+)—they increase the threat of entry.

Existing firms in the wider business financing industry could also become competitors to Genesis by capitalizing on their customer and supplier relationships within the channel or leveraging capabilities that Genesis does not yet possess, such as production, marketing or distribution resources and power. For example, an investment dealer could launch its own digital exchange by buying or licensing an exchange technology and integrating it with its existing systems and customers. They might be behind Genesis in terms of technology deployment, but ahead in terms of building the supplier and customer channel. The NYPPE did this in the US. Initially a securities transfer agent, through acquisitions it created a digital marketplace for secondary trading of private securities. An existing competitor within Canada might be able to do likewise. Firms that already serve market participants then pose a very real entry threat; the ability to access existing distribution channels is a (+) factor.

As noted in the discussion of Genesis' services, an ultimate objective of any type of exchange is to provide liquidity to its participants. This is accomplished by reaching a point of critical mass, where there are sufficient buyers and sellers such that the likelihood of completing a transaction is high, if not almost assured. Not unlike a public stock exchange, eBay is a classic example of a marketplace that has achieved liquidity, in part through network externalities. Network externalities are created when the value of a good to one user depends on the number of other users. In eBay's case, as more buyers began to use the service, it became more valuable for sellers. The number of sellers grew, causing the volume of buyers to also increase. As a result it is the dominant online auction and has created barriers to entry for its competitors.

While network externalities are valuable but not essential to build a profitable exchange, it should be possible for an exchange in the Canadian private securities market to build sufficient critical mass where enough issuing companies and accredited investors are participating that each participant has a reasonable potential to conclude a deal, and trading transactions will clear. The value of the exchange would increase as more participants entered because adding buyers (sellers) increases competition and benefits sellers (buyers). These buyer-seller network effects contribute to economies of scale, which in turn can lead to liquidity. Economies of scale exist whenever long-run average costs decline as output is increased.²³ Additional paybacks from economies of scale to the exchange could include further specialization of tasks leading to further systemization of processes, which contributes further to the lowering of unit costs. However these benefits are somewhat mitigated by the big advantage that Genesis and any other computer-based exchange derives from heavy reliance on scaleable technology—that significant increases in output (customers transactions) can be absorbed without commensurate increases in input, i.e. technology. An example of the power of technology to scale is Moore’s Law, which says that computing power doubles, and the price halves every 18 months.

However, this reaching of critical mass has not yet occurred, and the potential for it acts as another incentive for competitive entry, especially to the degree that it could then become a barrier to entry or a competitive advantage. Moreover, Genesis believes that given the size of the Canadian market and the need for sufficient economies of scale, there may be room for only one private equities exchange, or two at the very most.

“Apart from economies of scale, established firms may have a cost advantage over entrants simply because they entered earlier.”²⁴ To the degree that existing participants in this market possess cost advantages, they will reduce the threat of entry. Existing offline companies

²³ (Baye, 2003, p.183)

²⁴ (Grant, 1987, p. 59)

like larger law firms and investment dealers have several cost advantages. They have an existing base of customers, in some cases quite large, and so will not have the customer acquisition costs of newer firms like Genesis. As well, they possess economies of learning in their fields of expertise such as conducting primary placements. Absolute cost advantages are currently moderate in this market and like all of the preceding entry threat determinants, it is rated as a positive (+) entry threat factor.

If an established firm can create barriers to entry through differentiating its product (or service), it can reduce the threat of direct competition. There are four aspects to this market as defined earlier, and the different participants each deliver varying types and quality of service. As well, these services can be based on specific customer industry experience, knowledge, and relationships. As a result there can be significant differentiation. Some firms possess advantages of customer loyalty, and to a lesser degree, brand recognition, such as that of a prominent law or accounting firm. When product differentiation is high, entry threat is lowered, and so is rated as a (-) on the model.

Given the highly regulated nature of the financial industry, there are also regulatory factors that influence the competitive environment in the private equity capital market. In many cases firms in the industry cannot even operate unless they have licenses, approvals or certifications from regulatory bodies, and each Canadian province has its own separate body of law and securities commission. Even firms involved in the issuance and trading of private securities are subject to regulation; in most cases they must be granted an exemption from law that otherwise prohibits trading. All of this has a lessening effect on competition, by keeping some potential entrants out of the market who cannot or do not want to go through the approval process.

As well, there is always the potential for regulatory change, which creates risk for firms and reduces incentives to enter. Regulators play a critical role in shaping the industry, and they are outside the control of the firms within it. A significant industry event or technological innovation, or change in government or policy can have a considerable affect on financial markets.

Intellectual property law and the ability for firms to file patents in a much broader range of disciplines and practices may also have a competition-lessening effect. For instance, Genesis Exchange has filed several patents for features in its exchange, which if approved, could provide the company with some protection from competition for a period of time.

However, one of the government-led changes in the public stock markets may have a different effect on the private securities market. Recent events in the public securities markets in the US such as the Enron and WorldCom scandals have caused governments to significantly increase the requirements and obligations that publicly traded companies must comply with. This in turn has boosted these firms' already high legal, accounting and other compliance costs. Consequently, a growing number of private companies are rejecting or reconsidering the "go public" route as an option for securing needed capital. In addition, existing public companies are now considering the benefits of taking themselves private. This trend of growing regulation and cost of public market governance may have contrasting effects on the marketplace. It may contribute to a growth in the demand by medium-and-larger sized customers for private capital investment, which in turn may reduce the amount of capital available for smaller deals. This then may lead to a further lessening of buyer power for smaller private companies. Alternatively, this could cause more suppliers to enter the market and thus potentially increase competition. As a result of this duality, this factor is shown as (-/+).

All of these Threat of Entry factors combine to create a “moderate” impact on competition within the industry.

2.5 Threat of Substitute Products/Services

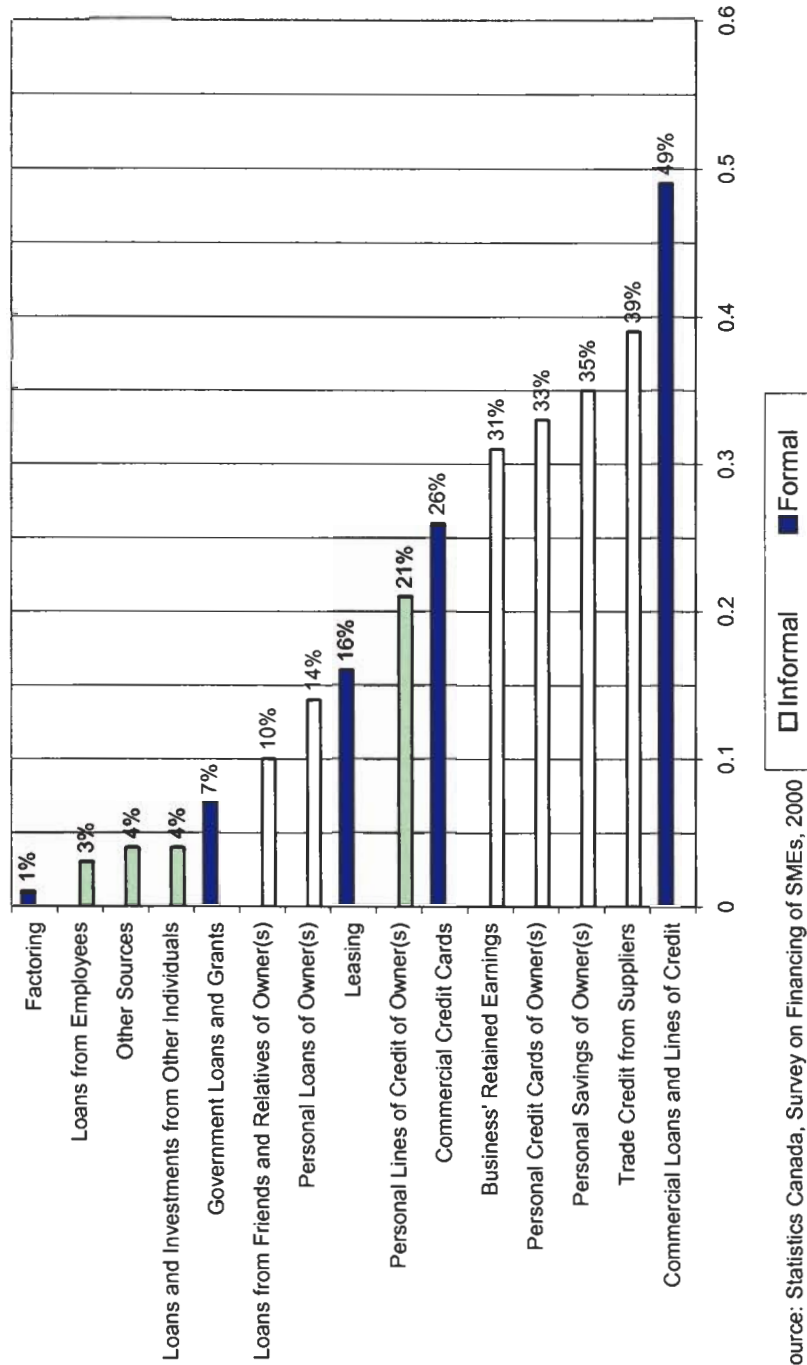
The price that customers are willing to pay for a product or service depends in part on the availability of substitutes. As a result of the following assessment, the Threat of Substitutes has been characterized as moderate to high. As covered earlier, products are defined as the various financing instruments available to private companies, and services are the complementary functions and services employed to deliver and manage the financing.

With respect to products, private firms have numerous alternatives to finance their operations. Risk capital is only one of many financing instruments available to SMEs.

Figure 2 shows the types of financial instruments that were in use in 2000 by Genesis’ addressable market—Canadian SMEs, across all industries.

Figure 2: Financial Instruments in Use by SMEs, 2000

Financial Instruments in Use by SMEs in 2000



Source: Statistics Canada, Survey on Financing of SMEs, 2000

SME creation and growth usually require several stages, of financing, involving a variety of instruments —depending on the type of business, its growth prospects, market conditions and a number of other factors. While debt is the most commonly sought-after form of external financing by Canadian SMEs, no business can be financed by debt alone; all businesses require an equity base.²⁵

SMEs use a wide range of formal and informal financial instruments usually in combination. Often product substitutes are complements, for instance, eligibility for some government grants requires a specified minimum amount of equity investment. Formal types of financing are obtained from sources external to the firms, which are in the business of providing financing. Informal types of financing are obtained from sources that are not in the business of financial lending, or are acquired through the business' activities (e.g. retained earnings) or from the owners (e.g. personal savings). In fact as evidenced from the chart, the various personal-based means of financing, in aggregate, often constitute the largest source of informal funding. Although rare, business owners can also employ non-monetary means of providing resources for their businesses, such as entering into a joint venture to acquire the assets they deem necessary. Note that the Statistics Canada survey excluded SMEs that had public stock ownership. In fact, small public stock issues by small companies have an extremely small chance of succeeding in Canada—on average, only 6% of businesses that launch an IPO are considered real successes.²⁶

As illustrated above, informal instruments are used almost twice as much as formal. This is especially predominant in the target market, where firms are typically young, small or operate in knowledge-based industries. They face supply-side constraints such as tighter lending conditions, not only because they lack the business assets that can secure debt but also because of

²⁵ (Industry Canada, 2003, p. 38)

²⁶ (Ibid. p. 161)

their higher risk environment. Problems of adverse selection, moral hazard and high verification costs all stem from the information asymmetries inherent in these types of businesses that lack a proven track record and stable cash flows²⁷. Although advantages to equity financing typically include little impact on cash flows and no fixed repayment schedule, many of the target customers have little choice to obtain equity financing given these constraints.

Certainly obtaining private equity financing from angel and other accredited investors has its drawbacks. It is more expensive than debt since risk capital investors typically look for an annualized return exceeding 20%; as well, any payments are not tax deductible. Moreover, in addition to giving up some ownership in the company, the entrepreneur will often have to cede some management control, for example, direct involvement in the business or a seat on the Board of Directors.

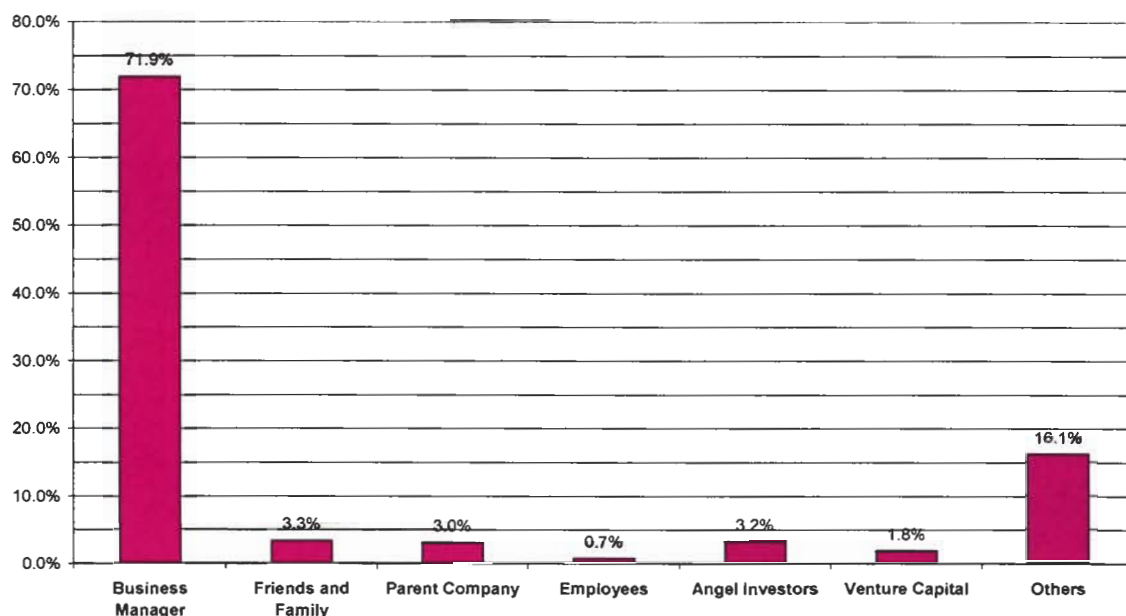
There are also demand-side factors that influence companies' decisions for financial instrument products. "The extent to which substitutes limit prices and profits (for the suppliers) depends on the propensity (and ability) of buyers to substitute between alternatives. This, in turn, is dependent on their price-performance characteristics."²⁸ Just as there are many different substitutes available, there are many different price points and performance characteristics of substitutes. For this reason, companies will naturally first seek lower cost investments, subject to factors discussed above. Internal financing can be expensive depending on the opportunity costs facing the business. Debt financing is generally lower cost than equity financing and has attractive price-performance attributes. As well, a joint venture or other partnership if crafted well can be significantly cost-effective. Some substitutes however have a high price for performance, particularly "going public" on a public stock exchange, with its attendant regulatory and legal obligations and costs. Among potential equity investments, entrepreneurs will also typically opt

²⁷ (Baldwin & Gellatly & Gaudreault, Valérie, 2002, p. 12)

²⁸ (Grant, 1987, p. 58)

for lower cost alternatives such as financing supplied by themselves, business associates and friends and family, before utilizing other informal investors farther up the “food chain” such as angel and accredited investors. This is subject of course to other factors, for example the availability of the amount of funds needed. This distribution of equity is clearly shown in Figure 3 below; the investor “food chain” moves upstream from left to right.

Figure 3: Equity by Source, Canadian High-growth SMEs



Source: Statistics Canada, Survey on Financing of SMEs, 2000

Price-performance characteristics are also important with respect to services. As covered earlier in the discussion about pricing, there is a wide range of types of providers and services in this industry, with their attendant costs. These costs are in part associated with the level of expertise and value-add services offered by the providers. They can range from inexpensive, such as to engage the advice of prospective angel investors and government institutions, to moderate

for VC's and some independent consultants, to expensive for law and accounting firms and investment dealers. As well, relationships come into play; a business owner typically has an existing business relationship with a bank or accountant who has a vested interest in up-selling and cross-selling to their client.

The price-performance characteristics of substitutes to private equity financing are varied, but can be considered slightly more favourable. However, the price-performance characteristics of the services are fairly well balanced. Therefore, in combination with a reasonably high propensity to substitute, on the whole, the threat of substitute products and services is moderate to high.

2.6 Bargaining Power of Suppliers

The chief suppliers to the brokers and service providers within the private equity capital market provide labour, technology, information and miscellaneous physical assets. The result of the assessment of the four factors that determine the bargaining power of the suppliers is that it is moderate at best.

There is reasonable competition for the supply of labour. Supply is low in certain areas, as growth in the financial services sector has led to a shortage of those with recognized financial markets/securities accreditation. For instance, the financial industry is now competing with more traditional businesses such as banks and insurance companies for staff in the sales and client services fields that have the requisite certifications. Additionally, although a past boom in the IT sector has led to an excess supply in certain fields such as programming, some firms in this industry, such as Genesis Exchange, demand only highly qualified and experienced personnel, especially the more complex their product or service offering is. For these reasons, many of the suppliers of labour to the industry have increased bargaining power.

As well, there is notable differentiation among the suppliers of labour. For instance, programmers can possess very different and specialized skills that can be potentially leveraged for competitive advantage in technology-based firms. Higher quality performance and greater experience are very valuable to employers. For example financial experts who can make insightful analysis and prudent recommendations and decisions can directly impact the employer's bottom line. Differentiation reduces the willingness of the employers to switch suppliers (employees) on the basis of cost. The above factors increase the bargaining power of suppliers of labour for discerning employers who are heavily dependent on their staff. On the other hand, Genesis employs staff and independent contractors to do data entry, for which there is not only ample supply but also less skill and differentiation involved; therefore these suppliers' bargaining power is reduced.

However there are several other weaker, but nonetheless relevant factors that mitigate this supplier bargaining power. Labour costs are a high proportion of total costs for many firms in this industry since much of their assets are intellectual capital and human resources. Consequently, employers are more sensitive about the price they pay. As well, there is low product differentiation in other supply areas, such as a firm's premises and general business equipment. With the exception of a few large firms that provide financial data services to the industry like Dun & Bradstreet, the majority of suppliers of information and technology have relatively low power because their products tend to be homogenous. Computer hardware and software has become relatively ubiquitous.

Overall, the assessment for supplier bargaining power is moderate.

2.7 Industry Attractiveness

To summarize the assessments of the five forces of the competitive framework, four are characterized as low or moderate. Only the threat of substitutes is characterized as high. The

attractiveness of the Canadian industry for the management and raising of private equity is a composite of all the factors discussed.

Weighing these out and taking into consideration the diversity of the market participants and its products and services, the conclusion can be drawn that in general, the industry is reasonably attractive. This depends to some extent however on the role a firm will play, which services it will offer and how those services will be delivered. For instance, the market for a private equities exchange for accredited investors that attempts to consolidate fragmented industry participants is indeterminate, and may not be successful.

One of the factors that can be the most telling of industry attractiveness, and either compelling or repelling to potential market entrants is the degree of profitability. In the case of the private securities market, profit margins at this time for many of the participants are good. The preceding analysis of the elements of the five competitive forces points to the basis for this profitability. As Porter says, “the most important determinant of a marketplace’s profit potential is the intrinsic power of the buyers and sellers.... If buyers and sellers are fragmented...their bargaining power will be weak and the marketplace will have a much better chance of being profitable.”²⁹ However, the moderately strong threat of substitution and entry may likely make it difficult to earn especially high profits.

Given that this industry is reasonably attractive, there are several probable outcomes. One is that the industry will continue as it has, with traditional service providers entering the market by specializing in corporate finance services for the private company market. Because this market is so fragmented, this will not have a significant short-term effect on profitability. No other competitor with a business model similar to Genesis’ will enter the market, at least until it is proven to be successful. Alternatively, another firm may indeed enter the market with an online

²⁹ (Porter, 2001, p. 9)

exchange model, either as a completely fresh entrant, an existing “traditional” competitor, or a firm with a similar model from outside Canada, such as the US’s Entrex. For this reason, Genesis hopes to capture a first mover advantage (FMA), at minimum in Canada. Issues with this strategy will be explored in Chapter 4.

2.8 Key Success Factors and Issues

The attractiveness of the industry from a participant’s perspective depends in part on how well some of the key success factors are utilized. These are the factors that determine a firm’s ability to grow and prosper, and serve to identify the potential for competitive advantage within the industry. Essentially, the factors reflect the demand and the competition, addressing how firms in the industry supply what customers want and how they survive competition.

It is useful to review the market as it was defined earlier, as the provision of the following functions for private companies that require financing: the storage and management of corporate shareholding information, company preparation for financing, the raising of capital, and the facilitation of share trading.

Spanning these market functions, customers, (investees and/or investors) want the following:

- Efficient and knowledgeable service and advice
- Low or reasonable costs
- Skills development
- Confidentiality and privacy
- Low risk
- Timely investment
- Well crafted investment deal structures
- The right investors

Consequently, given the competitive environment surveyed in the preceding pages, the key success factors for the industry are:

- Organizations need to have high quality, well-trained staff—after all this is a labour and intellectual capital-intensive industry.
- Effective differentiation or specialization will have to be delivered in order to generate and capture value in the market, especially to combat the ever-present and moderately high threat of substitutes, the strongest competitive force.
- Operational excellence in areas such as better technologies and superior service is critical in order to deliver exacting results.
- As well, given the nature of these services, companies have to provide industry-leading security and compliance practices and possess a solid reputation.
- Just as importantly, service providers need to provide their customers with access to high quality investors who can add real, measurable value to their clients.

These attributes are critical to meeting the identified customer demands. And, not least, for the higher level functions of raising capital and facilitating share trading, they support the ultimate end result that private firms need for their shares: a liquid, fair market.

Key issues facing firms in this industry therefore surround the difficulties in achieving these success factors. As previously noted, this industry is driven by information. Therefore knowledge management, particularly as administered, organized and delivered through people and technology, is critical in this industry.

However, most important is successfully brokering an investment that results in a win-win for both the investee and the investor—after all, this is the end goal. Firms that cannot deliver and build a track record of successful deals will not survive in the long run.

Genesis Exchange has an additional challenge—its approach is totally new and unproven. Therefore it will have to educate and persuade prospective participants and entice them to join when the benefits are not as appealing as they will be later.

3 INTERNAL ANALYSIS

3.1 Company Strategy

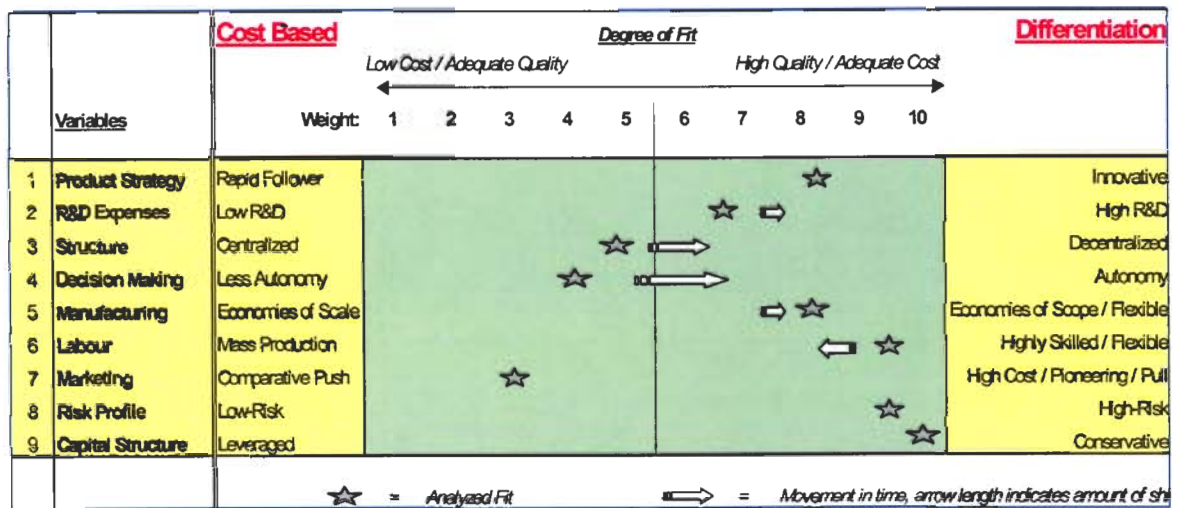
Genesis Exchange claims it has a Differentiation strategy, based on differentiating its service and adding value in the following ways:

- Product and Service Offering – The Exchange by its very nature is unique.
- Channel – Genesis Exchange is online, with most services delivered over the Internet.
- Focus: Segmentation – While the Exchange is a marketplace for private companies and private, accredited investors only, it is targeting the SME segment, where deals tend to be under \$10 Million.

3.2 Strategic Fit Analysis

Based on the following analysis, Genesis Exchange fits onto a Strategic Fit Chart³⁰ as shown below.

Figure 4: Genesis Fit to Generic Strategies



³⁰ (Bukzar, 2005, p. 19)

This chart lists the nine specific variables in the two “generic” organizational strategies that are analyzed below. The weight indicator for a variable assessed as it is today (2005) is shown with a star ☆. A variable that is increasing towards an endpoint (e.g. Differentiation) is shown with an arrow →. The numerical weights are for distinguishing gradation only.

3.2.1 Strategy Components

3.2.1.1 Product Strategy

The company founder describes Genesis as “a better mouse trap, a brand new approach to an age-old problem”—in other words, a completely innovative product. The Genesis Exchange claims it will solve the problem that private companies have in getting liquidity for themselves and their shareholders and inexpensively managing their capital while adopting good corporate governance. Further, it will solve the problem that accredited investors also have in getting liquidity for themselves while reducing risk due to poor investment information. Although it is called an exchange, as seen above, the strategy is to take it beyond the functionality of a standard stock exchange or ATS (Alternate Trading System). The Exchange is driven by patent pending technologies and uniquely automates many traditionally expensive but low value-add processes, such as shareholder votes and convertible debt management.

One of the marks of a differentiator is its innovation. It is not a follower. The company maintains that there is no product or service like it in Canada. From the descriptions above, that would be true. However, there are several companies in the US that are also going after private companies and offering share management and trading service, albeit they are pursuing different segments, e.g. large private companies, and offering different services, e.g. share transfers. As a result, it could be argued that Genesis is a follower in some areas of its business, at least if it chooses to expand to the US.

Another mark of a differentiator is high quality. This is Genesis's aim—the firm is pursuing a customer value proposition of operational excellence³¹. It has documented its “Distinctive Excellence” strategy as: “We provide our clients with a flawless experience through our focus on Operation Excellence in everything we touch.” In addition, its vision is to be the world's high performance benchmark. However the company is young and does not have a majority of its processes completely established yet, so quality cannot be adequately and ultimately determined at this stage.

A third mark of a differentiator is providing that high quality at adequate cost. Part of Genesis's strategy is to have low entry barriers for its participants; inexpensive and practical enough that every private company can afford to use it. It does this by charging low monthly subscription fees that are tiered commensurately with participant activity. This is being incorporated into the company's marketing strategy.

Given the above analysis, the company's Product Strategy is not completely aligned with a Differentiator's strategy, and so has been placed several weight “degrees” to the left of a classic Differentiator's right-hand position on the Strategic Fit Grid. Although an innovator does not typically take a low cost approach, this tactic fits with the company strategy.

3.2.1.2 R&D Expenses

As a percentage of its overall expenses, Research and Development is high, and through until late 2006, is forecast to be the largest expense in Genesis' operations. A very R&D focused firm in its first two years, R&D originally comprised about 75% of the company's costs, and has now dropped to under 50%. IT logically represents the lion's share of its development costs, given that it is an Internet-based business. It has developed its own proprietary software and algorithms in-house, as well as outsourced some programming to India. Genesis has conducted

³¹ (Kaplan & Norton, 2000, p. 3)

research into exchange trading systems and private company equity needs, as well as legal and other regulatory requirements. It continues to retain the services of consultants and its legal firm in support of ongoing product development.

From a broader perspective however, R&D invested as measured in total dollars is not high—less than \$1 Million in 2004, because the company is young. By comparison to the public exchanges and the development expenses of some of the accounting and legal firms that not only currently provide services to Genesis’s market, but could emerge as potential competitors, the R&D investment is not significant. Nevertheless, actual R&D expenses are expected to grow over the next two to three years.

As a result, again, the R&D Expense weight has been placed several degrees to the left of a Differentiator, but gradually growing higher. R&D does contribute strongly to Genesis’ strategy.

3.2.1.3 Structure

As a relatively young company, Genesis Exchange is currently somewhat centralized. It has one autonomous business unit, focused on Canada, to which the various business functions, such as strategy, engineering, and marketing and sales, are directed. This has been deemed appropriate for the company at this point, given its age, limited product, and its present market of only BC.

When additional markets are added, the company expects to decentralize aspects of its business, for instance, BC and Ontario are expected to become regional cost centers. As it grows, it plans to decentralize the functions within the organization that need market-focused performance, such as Business Development and Member Services. Unlike large organizations that tend to centralize their customer service operations, Genesis utilizes and in fact depends on local relationships and regional networks to grow its business and provide personal service.

From a physical operations perspective however it is geographically decentralized. The company maintains two offices and its staff are spread across four locations. In addition it is outsourcing for services from a firm located in Asia. Duplication is not a serious concern at this point, but the geographic separation creates some inefficiencies in general administration, communication and team performance.

While the company structure is not currently aligned with a classic Differentiator model, it will move closer in the next two years.

3.2.1.4 Decision Making

At this stage in the company's life, the President is involved in most aspects of the business and makes or directs many of the decisions. IT and engineering are the areas where there is currently more autonomy exercised by other managers. By the end of 2005 however it is expected that most of the functional managers will have assumed full authority and responsibility for their areas; the President has a track record of letting the reins go as the business grows. Indeed, the company values statement reinforces the importance of accountability and responsibility at all levels.

The President will continue to actively direct business strategy and corporate development, as could be expected. He also plans to remain involved in legal and finance, and product development. The former pair due to the regulatory environment that controls the company's actions; the latter is his personal passion. These areas will therefore be somewhat less autonomous.

While the current decision-making regime is necessary at this stage in the company's life, it is not a Differentiator's strategy. However by the end of this calendar year it will have permanently shifted closer towards being autonomous.

3.2.1.5 Manufacturing/Production

Genesis Exchange distinguishes its production in two ways: how the company produces its services, and how those services produce value for the company and its customers. As well, as is the case with other variables, there is a difference between Genesis' current position and where it expects to be one to two years out.

Genesis Exchange is an e-commerce ASP, and so its production centers on its online services. Therefore the production is predominantly performed by the IT engineering team. Given the skill sets of its labour force (see below) and the company's age, production processes are very flexible and the output is constantly adjusting to the needs of the company. For instance, database design, website user interface and functionality code development can occur simultaneously or sequentially during any given week. Economies of scope are important, based on its labour force, as described below.

There are several areas where economies of scale are also critical. Data entry of customer information is time consuming and voluminous. There are over a hundred pages of information that eventually get filled out as the customer's use of the Exchange matures. Therefore the company outsources a portion of this work to a firm in India. In another sense however, this outsourcing creates flexibility—the arrangement gives Genesis the ability to scale its customer base and manage growth surges and business cycles without having to invest heavily in related fixed costs. As well, the IT production is being built to take advantage of economies of scale, so that as Genesis's customer base builds and the volume of its customers' shareholders grows, a commensurate increase in staff (for example, engineering) will not be required. In fact, the profitability goals of the company depend on this scalability.

Generally there is a fit with the Differentiator strategy. It is primarily a flexible production operations strategy, although in time, as operations scale, it will moderate somewhat to the left, as the strategic fit chart shows.

3.2.1.6 Labour

Genesis Exchange's labour force is distributed across the following teams: IT, Business Development (including Sales, Marketing, Finance, Member Services, Data Entry, and Administration/HR.

The skill sets of people employed reflect a desire for flexible production across a wide scope of required outputs, particularly in IT. The IT team members are highly skilled and have broad experience. Many can work in most of the IT disciplines, such as code programming, databases, architecture, web development and networks. It allows the team to tackle different projects with the same resources and helps ensure continuity across platforms and programming. As the company grows however, it expects its IT resources will become more specialized and focused to take advantage of efficiencies of labour.

In the other functional areas, the team members are also highly skilled. For instance, the members involved in client services need to be well trained in the areas of financing and corporate management. Managers are typically multi-tasking in both managerial and hands-on roles. The main exception is Data Entry, which requires high accuracy but otherwise only moderate skill levels.

Clearly, the company's Labour force variable contributes to its Differentiation strategy.

3.2.1.7 Marketing

Genesis Exchange's general marketing strategy is to "cast the net wide" – appeal to the "Mom & Pop" operations and also to the larger companies within its target market of high growth

oriented, private small and medium sized businesses. The company deems a “pull” strategy to be neither efficient nor cost effective. A pull strategy involves using advertising and promotion to induce customers to ask intermediaries, or come directly to Genesis for the product. However, advertising and promotion through mass media cannot target the market segment effectively, and it cannot reach the prospects during their time of need—such as when they are preparing for or actively trying to source financing. Pull advertising is typically also expensive, and Genesis has limited financial resources.

Accordingly, Genesis primarily employs a “push” strategy in its marketing efforts. A push strategy is most appropriate where there is low brand loyalty and choice is made with the intermediary.³² The first two factors support the push strategy, especially in the early stages of the Exchange. A push strategy involves using an in-house sales force and inducing intermediaries to promote the service to end-users. Genesis uses the community of service providers, advisors and networks that a prospective customer would normally turn to. Although these groups were identified as potential competitors earlier in this paper, the Exchange’s marketplace makes it profitable for them to participate, effectively making them “distributors” of Genesis’ service. These include law and accounting firms, banks, angel investors, industry and technology associations, investment managers, securities dealers, and small and mid cap funds. The service providers utilizing the Exchange as a marketplace not only promote themselves and find new customers, but also directly deliver some of their services.

As well, Genesis plans to focus on creating reference-able clients—both issuing companies and investors—that would be heavily leveraged in promotion efforts. In addition, Genesis plans to use various viral marketing methods, partly in conjunction with the “100% reference-able clients” strategy, which will further reinforce its push strategy. For instance, it aims to create passionate customers who will not only evangelize to others in their local industry

³² (Kotler, 2003, p. 511)

community, but will also “write the advertising message” needed to communicate to other prospects. Further, Genesis is using a comparative messaging strategy because the contrast between using existing offline-world methods to accomplish the same results as Genesis delivers is so markedly different.

Genesis is using one element of a pull strategy but doing so by advertising what appears to be a cost-based marketer’s low pricing. As mentioned earlier, the prices Genesis charges are far below comparable costs that issuing companies would incur to manage shareholders and raise capital. For instance, a low monthly subscription fee is designed to attract small issuer companies by being equivalent to the price of a water cooler service. In fact though, Genesis is not intentionally using a typical cost-based low pricing model. While the price is low compared to traditional service providers, it actually represents a premium in relation to Genesis’ marginal costs, which are small because its software does most of the work. However, Genesis is using a pull strategy nonetheless, by taking advantage of its comparatively low pricing to penetrate the market.

The marketing approach then is primarily cost based, which although not that of a Differentiator, does contribute to the company’s strategy at this point in time.

3.2.1.8 Risk Profile

Genesis Exchange appears to have a split personality with respect to its risk profile. On the one hand, its own business model is reasonably high risk. It is an online business, so it is more critically vulnerable to software and hardware failures, denial of service attacks, viruses and other technology issues than other companies. It operates in a regulatory and legal environment over which it has not control, and must comply with stringent regulations. Breaches of exemptions by it or its customers could cause irreparable harm, and it may fail to obtain or retain the necessary approvals to operate its business in securities jurisdictions. As well, it is vulnerable to competition

from existing players in the investment and securities industry that could leapfrog the company. Genesis's risk mitigation measures include redundancy planning (for example, it runs its IT operations in two separate locations), and filings for various patents and trademarks.

Genesis Exchange has an additional risk—innovation. As mentioned above, its approach is totally new and unproven. Neither Genesis nor Entrex in the US have acquired a consequential amount of early adopter customers. There is no guarantee that this model will gain market acceptance.

However for customers, Genesis Exchange must be very low risk. Issuing companies and investors typically value their privacy and fear sharing information. They must have assurance of complete privacy of all their information (to the degree that they permit). Further, given the critical nature of the information, it must be secure. A company's capitalization table must be 100% accurate, and distributed shares cannot be lost, as they are in electronic form only. Investors must be able to completely trust the Exchange and the companies listed on it; for example the certification process must have bulletproof integrity.

The assessment of the risk profile is that it is actually very close to the classic Differentiator's strategy because the risk profile is concerned primarily with the company, as opposed to its service.

3.2.1.9 Capital Structure

Genesis employs a conservative capital structure. It is 100% financed by the owner and will only do high quality equity financing of the minimum amount if and when necessary. In fact, the company is determined not to go public. Although it does not plan to use any significant debt financing in the future, if necessary it would likely use convertible debt so that it would have the ability to convert the outstanding amount into equity ownership. The fact that equity financing is higher cost than debt is not a significant factor for the company.

Genesis Exchange's capital structure definitely contributes to its Differentiation strategy because it enables the firm to take on the aforementioned risks without unduly jeopardizing its own viability.

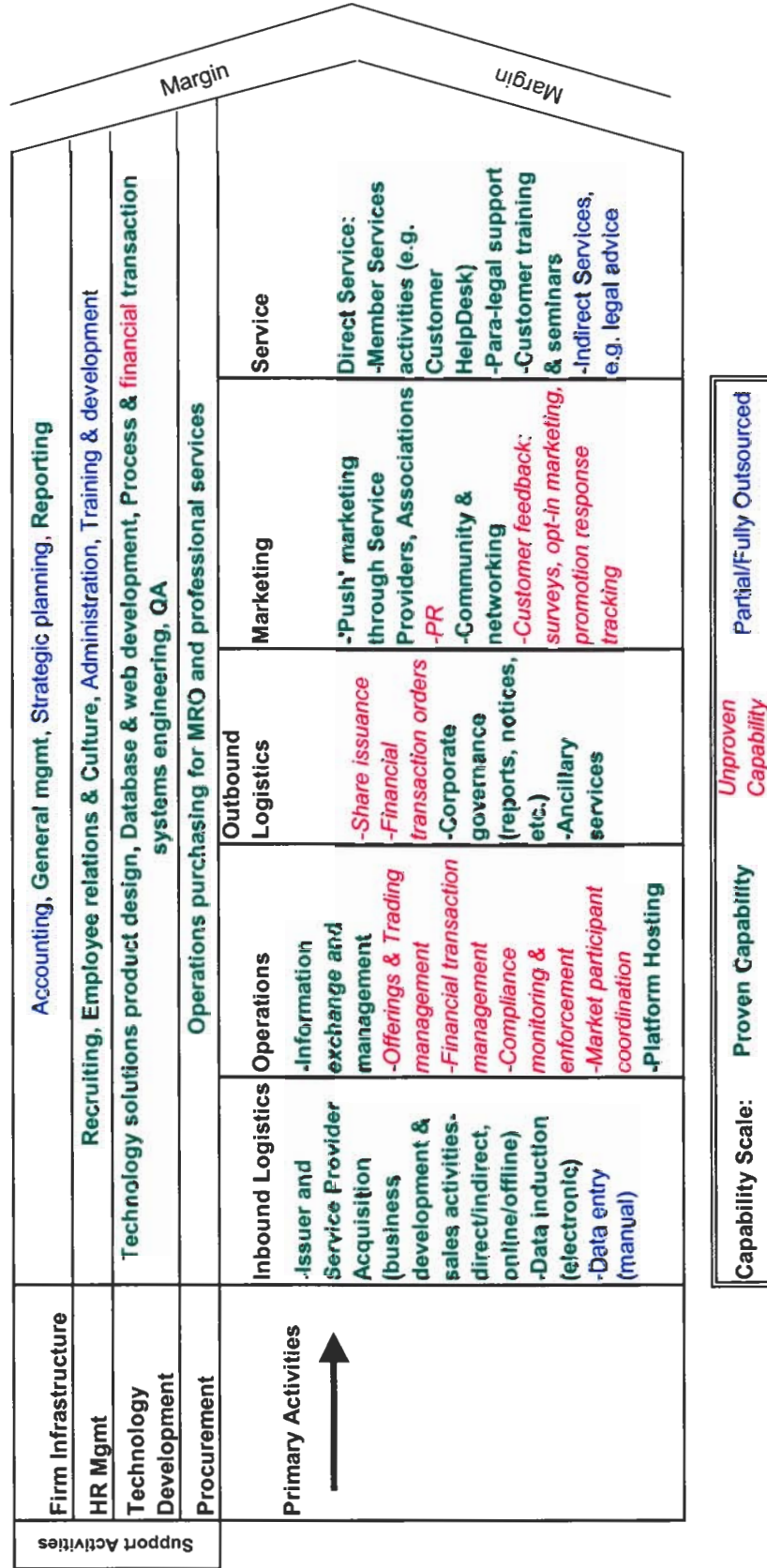
3.2.2 Strategic Fit Assessment

Overall, Genesis Exchange's degree of fit is somewhat aligned to a typical Differentiation strategy. As can be seen in the Strategic Fit chart, two thirds of the variables fall on the right half of the grid, towards the pure differentiator model. It is strongest with respect to its Labour, Risk Profile and Capital Structure. This is not unexpected, given that it is a young high tech company. Of moderate strength are the Product, R&D Expense and Manufacturing strategies. The latter two again are somewhat characteristic of a younger high tech company. Of the three variables that are not consistent with a Differentiator's strategy—i.e. closer to a Cost Based strategy—Structure and Decision Making are reflective again of the age of the company, and all are projected to migrate to the right over time. The Marketing variable stands out as the most non-differentiated variable, and it is not expected to shift towards a high cost, pioneering or predominantly pull approach. Sticking solely to this approach may not make sense for the company in the medium to long term, especially if it must build critical mass.

3.3 The Value Chain

The firm-level value chain for Genesis Exchange has been developed as shown in figure 5 below.

Figure 5: Genesis Exchange Value Chain



Source: Bukszar, 2005 based on Porter, 1985

The font type and colour identifies the nature of Genesis' capabilities, which are influenced by the young age of the company, that in turn makes it difficult to provide a detailed assessment of how it performs the activities (e.g. excellent, good, fair, poor, etc.). Bolded green font indicates that Genesis is currently performing this activity; moreover it is doing it sufficiently well. Italicized red indicates that the "jury is still out" on how well Genesis can perform this activity, chiefly because it has either not performed it long enough to be known, or it is a function that hasn't been deployed yet. Standard, blue font signifies that either the entire activity or a significant portion of it is outsourced.

"Dot-coms need to create strategies that involve new, hybrid value chains, bringing together virtual and physical activities in unique configurations".³³ Genesis Exchange is indeed unique in its industry, as the following discussion of its various value chain components reveals.

3.3.1 Primary Activities

Since the 1980's, "IT has permeated the value chain at every point"³⁴. In Genesis' case, as an electronic information exchange with just under a dozen employees presently, it depends critically on technology throughout its firm value chain—computer systems and the Internet underlie much of its primary activities. Therefore some aspects such as functionality and strategy will be covered in the following discussion of primary activities. The more technical facets, such as infrastructure and technology disciplines and practices will be dealt with as a support activity.

3.3.1.1 Inbound Logistics

The input logistics for Genesis Exchange differ from more traditional means of acquiring inputs because of the intangible nature of data. The "Procurement" support function focuses on the operational procurement activities.

³³ (Porter, 2001, p. 16)

³⁴ (Porter & Millar, 1985, p. 3)

The dominant inputs for Genesis' primary activities are the issuers and their data. Even though Genesis plays a broker role, the issuers are essentially the "inventory" of the business—their equity is sold to investors. Another benefit of focusing on issuers is that virtually all of them "stock" the exchange with investors—their existing shareholders. This automatically builds the Exchange's investor inventory, especially when the shareholders are high net worth individuals—they are potential investors in other issuers.

Service providers such as law firms are also part of this strategy, particular those that focus on servicing private firms seeking financing, since they are also a good source of issuer inventory. Candidate service providers are put through a certification process to ensure they meet Genesis' standards.

The primary means by which issuers are acquired are through business development and sales activities, as opposed to the purchasing function of a traditional hard-goods business. Issuers are contacted and persuaded on the benefits of joining the exchange by Genesis' sales team. This is done through a combination of direct outbound calling and in person meetings as well as indirect networking. The sales channel is direct and indirect—both Genesis staff and its service providers sell Genesis' services. Sales prospecting is done online through prospects' websites and offline through telephone and face-to-face contact. The leads produced for sales prospecting are generated from various typical sources such as the member rosters of associations in target markets. Business development efforts focus on forming alliances with relevant associations and other groups of prospective customers, like the BC Technology Industry Association. Currently, service providers are chiefly recruited through the process of issuers bringing them into the system during the process of listing on the Exchange.

The actual logistics of delivery are of course mainly achieved by electronic means. The raw input is primarily data, and is inducted into Genesis' systems. Certain files can be uploaded

directly by the customer into the “document vault”, a secure storage area that requires special permission to access. In other cases, the issuer’s data is either only in hard copy form or cannot be conveniently transferred from a legacy (older) computer system. In these instances, the customer or Genesis enters it manually into the online system. While Genesis staff performs some of the data entry, the majority is currently outsourced in one of two ways, depending on the nature of the data. The most routine data entry—for example, public information on the company—is carried out by a firm that utilizes workers in India, whereas controlled and qualified local contractors enter the more sensitive data such as historical, existing shareholder information. Contracting out the data entry enables Genesis to more easily match this labour-intensive manual function to customer demand and scale it during peaks in business. In all of these scenarios, the customer provides the data, either from their website, in-house materials, or directly as a data file.

The data is the information about the issuers that Genesis requires in order to maintain compliance with securities regulations, and that prospective investors will need to evaluate the issuers. This information is grouped in 4 areas: Issuer Profile, e.g. products, markets, and management team; Legal, such as board minutes and contracts; Financial, including past financial statements and projections; and General Due diligence including the business plan, salary schedules and the essential capitalization structure.

These two primary inbound logistics activities are proven capabilities for Genesis.

3.3.1.2 Operations

Genesis’ production activities are focused around information and its exchange between the marketplace participants. For instance, Genesis’ system takes information from private companies and delivers it or makes it accessible—according to the restrictions and privileges set by the issuer—to existing shareholders and potential investors. Information management is the foundation of the exchange and the critical component in good issuer corporate governance,

which in turn is a cornerstone of the exchange's value proposition. It is essential that the Genesis system manage the information so that it is accurate, complete and timely. For example, it must ensure that an issuer's capitalization table is constantly reconciled—a change in the share holdings that is updated in the database must be immediately communicated to all other shareholders. It also must manage the process according to the rights and restrictions (aka legending in the offline securities world) that pertain to the specific share issue.

The system has been developed so that much of the information exchange and management work, including the examples described above, is automated by the computer programming and requires little intervention from Genesis staff. However there are checkpoints in certain processes that require the involvement of a staff member. For instance, when an issuer wants to list on the Exchange, they must request a legal confirmation letter. This allows Genesis to personally review the applicant's progress in completing the "Steps to List" checklist, as well as to coordinate the payment of listing fees.

The share offering and trading systems are the real heart of the exchange functions. For a primary offering where stock is issued out of a company's treasury, the issuer or their service provider completes a series of forms that detail how the offering will be conducted. It starts with general information about the determination of price and volume, accepted forms of payment, and cancellation and expiry criteria. The issuer next specifies what Securities commission exemptions the shares will be issued under, whether share vesting will be permitted, and what rights and privileges will be attached to the securities. The issuer then publishes the general offering to the investor community and specifically invites known investors and existing shareholders. The issuer or their service provider subsequently uses the Genesis Order Book system to manage the offering process much the way an investment bank does behind the scenes for large public and private placements. The issuer can view the investor pipeline to see who is bidding and if they have actually made funds available. They can also edit the bid details and send back responses to

the bidding investors, as well as create and deliver generic or customized documents to the bidders of their choice. Finally they can measure the bids against pre-set targets, and close the offering with all or selected bids only.

As mentioned earlier, the secondary trading system has not yet been built, but it will utilize an interface similar to those used by online “self-serve” brokerage firms and like a public stock exchange, will permit shareholders of private firms to trade their stock with other investors who have qualified and accredited themselves on the exchange.

Both of these functions require an important operational activity—financial transactions. Recurring fees payable to Genesis are typically made by credit card, whereas funds for the purchase of securities, as well as non-recurring Genesis fees are transferred from shareholders through Genesis’ settlement accounts, and then credited to issuers or other shareholders as applicable. Genesis’ financial systems are integrated with its bank’s electronic funds transfer services to make the transmission of monies occur seamlessly in Canadian or US currency and in either country. The company has created an innovative payment method called “PayGo” whereby investors can subscribe to purchase shares on a recurring basis (e.g. monthly) by automatic funds transfer. This gives the investor the benefit of avoiding a large outlay of cash, especially if the investment is risky, while giving the issuer the advantage of receiving regular incoming equity investment cash flow.

The monitoring and enforcement of market participant activity is one more essential operational function. All participants in the Genesis Exchange must be in compliance with the various applicable federal, provincial and state securities regulations that govern private securities. This is particularly important because the regulations that protect the public from unscrupulous promoters and traders on public markets are absent in a private exchange. The

exemption issued to the company by the Securities Commission is partly contingent on the company's ability to police the exchange's activity, pursuant to securities regulations.

Genesis employs several levels of security to guard against this. For instance, the system requires that all participants make a declaration as to the exemption(s) from public market regulations that they qualify for in their jurisdiction (e.g. Province or State). Genesis staff also conducts verification checks on participants, and is requiring Personal Information Forms to be filed by executive managers, e.g. CFO's, who have the power to move large amounts of company treasury funds. In addition, since Genesis Exchange acts as an intermediary, it informs the market participants through disclaimers that Genesis has made no independent verification and further that the company makes no representations, warranties or liabilities for any of the issuer materials and information.

Another "production" function of Genesis beyond the trading system, is the coordination—electronically and manually—of the market's participants. For instance, when an issuer conducts a primary offering, the service providers that will provide legal and accounting support must be properly associated in the system to the issuer and be given appropriate rights by the issuer to act on behalf of them as necessary. Although issuers have the ability to do this autonomously, they prefer to consult with Genesis staff. As well, the pick up of shares by shareholders must be electronically coordinated with the stock issuer's cap table and the shareholder's account and portfolio. As well, completed trades require the timely reconciliation of funds transfers between parties. A manual example is the coordination of Genesis' law firm receiving the issuer legal counsel's form letter and then reconciling the system information to the actual company records during the issuer listing process.

An additional operational activity is the actual hosting of the exchange platform. Genesis technical staff keeps the hardware and software running on a 24 x 7 basis. They must sometimes

provide customized support for customers, such as special, non-standard data manipulation. They also perform routine maintenance tasks including such activities as the updating of programming code and backing-up of files.

As indicated by the red font color in the firm level value chain figure, much of the operations described in the preceding paragraphs are either working in only basic forms or are in development stages. They are functions that Genesis needs to have capabilities in, but given their complexity and the company's early stage, the company's capabilities are not sufficiently known at this time.

3.3.1.3 Outbound Logistics

There are a number of outputs from Genesis Exchange's operational functions. As with the other primary activities, they are information-based and so rely heavily on technology. Primary offerings and secondary trades produce digital shares that must be electronically issued to shareholders. For instance, when a new issuer joins the exchange, they invite their existing shareholders via Genesis mail and external email to come in and pick up their pre-existing shares, which are now represented electronically in Genesis' system. The shareholder clicks on a special, unique link in the email which brings them into the Genesis website, confirms their agreement with the share information, and then creates a personal account and portfolio if necessary into which they then electronically "deposit" the shares.

The issuance or transfer of securities conducted through the system not only requires management of participant's accounts, but also naturally necessitates a corresponding transfer of money or delivery of capital. Therefore the Genesis system creates electronic banking "orders" which are transmitted to its bank (and subsequently to other applicable financial institutions) as industry-standard electronic funds transfers (EFT) over the Internet. Genesis' bank debits and

credits Genesis' settlement account and investors or issuers bank accounts according to the nature of the specific transaction.

The corporate governance controls also create a variety of outputs, such as notices, reports and information circulars that are transmitted by issuers to shareholders. Other forms of communication sent out by the system include emails, and news and press releases. These reports and notices are standard in the securities and corporate law industry and so Genesis' in-house staff has the necessary competencies to produce them.

There is also ancillary output, which is often delivered physically, by Genesis and also frequently by affiliates of Genesis. Service providers can supply their specific services through the system as described earlier, or they can deliver them in conjunction with Genesis Exchange. For example, Genesis conducts training seminars for private companies where portions of the agenda are devoted to corporate law issues, and is delivered by lawyers. A new unique service being offered by Genesis is an investor road show, where selected issuers tour cities by chartered aircraft, presenting to accredited investors. The investors are invited to enjoy a meal that is followed by tableside presentations of investment opportunities, given by the issuers who rotate amongst the tables every ten minutes.

Genesis Exchange demonstrates sufficient capabilities in corporate governance and ancillary services, but the share issuances and financial transactions are outputs of the yet-unproven primary offerings and trading management systems.

3.3.1.4 Marketing

As discussed earlier, the company employs a push strategy for the majority of its marketing. The main avenue for reaching its issuer customers and raising awareness is through the various industry groups and service providers like law firms and accountants, as well as word-of-mouth referrals. Genesis's system allows the providers to generate higher margins by

performing some services for their customers in a more automated and cost-effective manner, yet billing at their regular rates. As a result, they promote Genesis Exchange to their clients. Investors are also a strong referral channel because they have a vested interest in getting both prospective and existing companies they are currently invested in to use the system—it forces a corporate governance discipline on the issuer that reduces investor risk.

Genesis currently takes a low-profile approach to PR, using its relationships within the industry and avoiding the cost of outsourcing this function. The BC private equity and investment community is small enough that Genesis can benefit from networking and leveraging its relationships.

As part of its online approach, Genesis is able to cost-effectively obtain customer feedback. It uses surveys to solicit information about an issuer's capital-raising plans, or an investor's future investment plans, and then aggregates the data to ensure privacy of information. As would be expected, it employs other standard web-based customer-centric marketing tools such as opt-in marketing and promotion response tracking.

Led by its CEO, Genesis has existing expertise and experience with push marketing techniques and community networking. However the other components of its Marketing activities have not been performed long enough for the company to claim them as a proven capability.

3.3.1.5 Service

Genesis provides direct and indirect service to its customers. It utilizes a member services team that provides support to all three market participant types—issuers, investors/shareholders, and service providers. This team primarily uses telephone, email, and Internet chat to support its customers, however it also employs richer mediums like training seminars and personal meetings. Many of Genesis' target customers participate in educational seminars that cover such areas as

corporate governance, basic financing principles, strategies for raising money, and understanding and presenting successfully to angel investors.

Genesis employs two types of staff to service customers in operational and service-oriented roles. Member Service Representatives (MSRs) handle the more routine, non-legal support work such as answering basic customer questions, helping them use the web system — such as the document vault or the due diligence folders—and troubleshooting general problems. Trained, in-house legal assistants or paralegals perform work that requires more knowledge of corporate law, including understanding aspects of corporate governance and financing as they relate to the private equities markets. For example, many issuers do not understand that securities law exemptions must be used when shares are both issued and accepted, otherwise they are not in compliance with regulations. They spend time a significant portion of their time helping customers get their capital structures organized and entered correctly into the system, since many of these small companies frequently have not kept their corporate law administration in order.

As would be expected, some support matters are too complex for Genesis and so it outsources those to appropriate Genesis-certified service providers. For example, legal issues commonly arise that can only be handled by a competent and qualified attorney. The company has proven capabilities in its services with the exception of these outsourced professional services.

3.3.1.6 Primary Activities Summary

The experience of a typical but fictional new issuer that joins and lists on the Exchange and conducts a primary share offering provides a good summarization and example of Genesis' current primary activities process. A Genesis sales member uses a technology association's member's list to identify "ABC Technologies" ("ABC") as an emerging growth, private company that will likely need to raise capital within the next year. A call to the CEO of the company is

then made and ABC decides to list on the Exchange. ABC designates an employee to act as the administrator of their Genesis account, and on a subsequent telephone call, a Genesis MSR guides the administrator in how to register and setup the company in the Genesis system, and walks through the steps required to apply for a Genesis listing. ABC also elects to send their administrator to a one-day seminar for in-depth Genesis system training.

The following day, with the help of system guides, the administrator enters ABC's general corporate and billing information, and completes the issuer's profile that completely describes the company to all Genesis users. With the help of ABC's CFO, the administrator then obtains the company's capital structure information. It is only available in paper format, and contains close to 100 shareholder records, so ABC decides to hire Genesis data entry services to help. Upon entry completion, ABC and/or its law firm send to Genesis an Application for Listing which includes a summary of the company's capital structure. Genesis' law firm then reconciles the application information against what has been entered in the system and gives a "green light" to Genesis, who then approves the listing. ABC selects the level of corporate governance they commit to providing to their shareholders and Genesis activates their listing, which allows ABC to finally be seen by others (the specific Genesis users or user classes that ABC permits) on the Genesis Exchange. In addition the listing allows ABC to utilize many other features including shareholder voting and communication.

Since ABC needs to raise money, it wastes no time in conducting an offering on Genesis. The CFO and CEO meet with their advisors—in this example, their law firm—and discuss their specific financing needs and decide to have their lawyer manage the offering for them. The lawyer registers on Genesis as a service provider and ABC grants her the appropriate access to their company account. The lawyer, who has one of her firm's paralegals join her to learn the system for performing future client work, creates the offering from her office computer by

working through the offering “tabs”. A Genesis paralegal is assigned to monitor the offering and support the client as required.

First she enters basic information, for example the instrument type that will be offered. Then in the “Details” tab she indicates whether “Paygo” will be used, the method of price determination (e.g. fixed price or Dutch auction), what types of consideration (payment) will be accepted, how the total volume of shares will be decided, and the timing of the bidding process and cancellation allowances. Supporting documents are also uploaded in this step. The “Exemptions” tab specifies which securities regulation is being used to offer the securities and the “Qualities” tab is used if vesting (incremental ownership of shares over time) is permitted. Finally the offering services that ABC requires are selected in the Fees and Billing” tab. The offering then goes “live”, which means that it is published to the site for all users who can qualify themselves to bid, as well as sent by email invitation to those specific individuals that ABC chooses.

Interested investors then respond to the offering, accredit themselves, and then move through tabs similar to those that the issuer filled out, specifying the details of their bid for the shares. ABC and their lawyer meanwhile use the “Order Book” tab, as described earlier, to manage all the received bids, negotiating and accepting bids until they choose to close the offering. Genesis’ system then electronically debits the bidders’ bank accounts or credit cards, collects the funds in a trust settlement account and finally credits ABC Technologies with the funds after deducting offering fees.

3.3.2 Support Activities

Just as Genesis Exchange’s technology substantially affects its primary activities, so too, it influences its support activities. An additional causal bias in Genesis’ support activities is the

founder's philosophy to minimize fixed staffing costs and to utilize contractors wherever possible.

Genesis currently contracts with external companies to provide some of its infrastructure. The company has set high goals for itself and what it aims to achieve, and therefore effective strategic planning is recognized as critical to the company's success. Senior management does have competencies in this area, but it is so crucial that the company employs an outside strategy-consulting firm to facilitate and coach this process. It also currently outsources some of its accounting functions, but as more of this is automated and as the business grows, likely only the tax and auditing functions will remain externally provided. The company's management has dozens of combined years and a strong track record of successful general management, as well as creating and using reporting tools to measure and grow the business and its processes.

Genesis regards its employees as a crucial component of its competitive advantage, and therefore it will not outsource some critical aspects of HR such as recruiting, employee relations management or culture. However it utilizes external providers for some portions of general HR administration and training and development where these can be provided more effectively than its own resources allow. Currently the VP of Canadian Operations and the CEO personally do all of the hiring, including job description creation, advertising, interviewing and reference checking. All employees report directly to one of the two, and they actively communicate if not closely work alongside the employees throughout the day. The culture, as described further below, is actively guided and maintained, and relations with the staff are therefore also extremely good, given the company size of just close to one dozen members and the close span of control.

The majority of technology development is part of Genesis' core competency, and so it performs these key functions in-house. In fact, the specific design, product development and programming of its databases, transaction systems and web interfaces form part of Genesis's

competitive advantage. To this end, it has applied for several patents that touch some of its crucial systems: the Constant Reconcile Cap Table, the Integrated Securities Restrictions System, the GENSX Filing System and the Shareholder Alert System. As well, quality assurance activities are also performed in-house—they are important not only because of the financial impacts of the systems, but also to maintain control over the proprietary technology. However, the IT infrastructure is not proprietary nor critical to the company's competitive advantage and so Genesis looks to outsource components of it. For example it is planning to complete the outsourcing of CRM (customer relationship management) software to an ASP.

The VP of Product Development formally leads the technology team, although as mentioned earlier, the CEO plays an active role in this area. The CEO has unique product development talents as well as conceptions and ideas for Genesis' services. Product development starts with him; he takes his ideas as well as input from staff, customers and legal counsel and meets—often virtually, by phone or net meeting—with the VP. It is at this stage that Genesis creates its proprietary intellectual property, and from which past patents have been generated. VP and the CEO then turn drafts the scope documents that will guide the main programmers, as well as creates the user interfaces (UI), that is, the layouts of the web pages that the users will eventually see. The lead developer then finishes the detailed design and specifications and distributes the work amongst the programming team to be coded on development servers. An assigned quality assurance (QA) tester checks the work, which is then migrated to the user acceptance testing servers so that Genesis staff can test the programming to make sure it works as designed. Identified bugs and requested enhancements are documented by all of the testers and users in special tracking software. After numerous iterations of re-testing, the lead developer then builds the migration scripts and moves what is now a new software version to the production system for use by Genesis customers. While the process is not unique, the software that is created is.

The Procurement activities, which are handled by the operations and administrative staff, include the buying of maintenance, repair (limited) and operating equipment and supplies, and the contracting of professional services for Genesis' internal needs. Besides the normal needs of an office, the technology operations require expenditures on hardware and software and related support. Senior management is tasked with procuring the legal, accounting, consulting and other professional services that the company consumes. None of these needs are currently large and thus Genesis performs these competently without the need for a full-time buyer.

3.4 Key Suppliers

An examination of its Firm Level Value Chain reveals that the company is performing most of the identified activities in-house, with few external suppliers. The earlier discussion of Supplier Power further illustrated that Genesis' key suppliers are actually internal suppliers of labour. The IT employees are the most critical, given the company's heavy reliance on technology. Without the specialized expertise and experience of its programming team, the company would not be able to deliver its services—in fact it would be largely incapable of operating its business. The software developed by the team is the online system which the customers and staff both rely on to accomplish their tasks, whether it be managing shareholders or conducting and bidding on offerings in the case of the customers, or transferring investment funds and monitoring trading in the case of staff. While the company focuses on superlative treatment of all staff, these in particular receive high salaries and significant emphasis is placed on cultivating strong relationships and team spirit. We have seen that high quality staff is a key success factor for firms in this industry.

While it could be argued that suppliers of the technology infrastructure that keep the business running are also key, the products and services are readily and widely available in

sufficiently high quality from many suppliers, and the company has no need for special relationships or contracts.

In fact the other key “suppliers” that are critical to Genesis are the relationships or alliances with the “suppliers” of the capital. These are the other essential half of the brokering equation, and while Genesis’ founder has a limited network of relationships in the Vancouver market, the company has not yet developed strong wide networks and relationships throughout BC.

3.5 Technological Changes

IT has revolutionized the businesses world in the last few decades. In the mid to late 1990’s the Internet was initially viewed as primarily a disruptive technology, however it has evolved to sustain and improve the performance of many businesses and their existing products and services. Likewise, Genesis views its business model as complementing the private investment industry, not disrupting it. The company naturally views the Internet as being the enabler for its business model. Without it, it would not be possible to take the best aspects and disciplines of the public stock markets and provide them affordably to emerging growth private businesses as a central management system for private investment.

Consequently, technological change has been vital for Genesis. It has allowed the company to create and deliver its service, through the automation of existing offline processes. As the Internet continues to penetrate business and personal life, consumer behavior continues to evolve and Internet adoption increases. Genesis depends heavily on customer acceptance of its ASP model and system because it enforces corporate governance on issuers who may be resistant at first, and eventually requires customers to convert from manual processes and hard-copy documentation to digital processes stored on Genesis’ servers.

3.6 Core Competencies

Genesis has proven capabilities in two thirds of its support activities, and approximately one half of its primary activities. These are not the same as core competencies, which are those activities that are capable of being the competitive basis of a firm's businesses. Core competencies are not products or markets but, rather, business processes or skills.³⁵ In fact, they are so crucial to a firm's competitive advantage that they and all related aspects should never be outsourced.³⁶ This imperative means that Genesis should have its core competencies in primary activities, particularly in operations.

As the firm level value chain's font coding shows, Genesis is still developing its capabilities and competencies, moving inward from the outer primary activities, as the company matures. Whereas inbound logistics had been established and developed earlier in 2004, and service activities—which are relatively straightforward—had been ironed out by the end of the year, the company only commenced operations in December 2004. Genesis has not sufficiently developed any core competencies in its primary activities at the time of this writing.

As mentioned earlier, Genesis' core competency at present lies just in its technology—both in product development and programming, shown as a support activity housed within the IT department. Its CEO has unique conceptions and ideas for the service and its design, and the development team has strong competencies in engineering process and financial transactions systems, building databases, and using web development to “wire” them all together.

3.7 Culture and Organizational Structure

Drawing on previous experience, Genesis' founder crafted and documented the company's values at the outset. The founder wanted to play a major role in establishing the

³⁵ (Aaker, 2001, p. 141)

³⁶ (Bukhszar, 2005, p. 49)

values, ethics and standards by which the company operated before employees created it haphazardly. He believes that the traditions, rituals and history of the company must be consciously created. These values shape and define the company culture, which is based on principles and self-discipline, not rules. The company has hired employees with high standards and work ethics, which also reduce the current need to monitor adherence to the principles.

The culture has been articulated around four primary themes: character, ethics, performance and expectations. Each member is individually and collectively accountable, determined and disciplined, and counted on to assist whomever, whenever. Each person is committed to functioning on the basis of trust, integrity and respect; in fact, demonstration of ethical behavior is mandatory for every participant in the Exchange, in order to be compliant with Securities regulations. Individuals and teams strive for the highest quality work possible, and the company strives to ensure that performers prosper (as the company grows). Expectations of each member are high because the goal is to build a great company, not just a good one.

While a company can define its values and attempt to create its culture, in fact culture is the product of the attitudes, beliefs and behavioral assumptions of the social group within an organization, and organically learned and passed on within that group. As it turns out, the articulated culture is reasonably close to the actual, in part due to the company's small size and early stage, which is helping to foster a positive culture. The general mood is buoyant—the company is still in building mode, there have been few setbacks, and the promise of success has been reinforced by initial but early traction in the marketplace and the encouraging comments and opinions from company advisors, observers and customers. Although geographically dispersed, staff is tight-knit and focused on achieving each milestone and reaching company goals.

The current culture is non-hierarchical and non-bureaucratic, even though the founder is currently quite involved in much of the decision-making as mentioned earlier in the discussion on

strategic fit. It encourages autonomy, which is key to helping the company move to a more autonomous decision making regime. The culture is in synch with the overall strategy of differentiation.

Similarly, as mentioned in the earlier strategic fit discussion on structure, Genesis Exchange's organizational structure is currently not that of a Differentiator. It is centralized, which is mostly a function of the small size of the company, (less than a dozen employees in May 2005), even though it is geographically dispersed.

If the present culture is maintained, it is conceivable that the company could leverage its current absence of boundaries, such that it might develop a borderless organization. "A borderless culture breaks down the horizontal barriers between functions and the vertical barriers between organizational layers. This means that employees are encouraged to collaborate with one another and given considerable freedom to turn their creativity into productivity."³⁷ This organizational strategy would not only fit well with the articulated values of Genesis Exchange, but potentially permit it to implement alternate structures in the future while maintaining some of the present benefits of its small size.

3.8 Financial Inspection

This project briefly examines Genesis Exchange's current financial state, bearing in mind that the company is young. Although Genesis launched its business publicly in December 2004, its revenue generating activities did not commence until January 2005, the beginning of its first formal fiscal year.

³⁷ (Business Week, 1993, p. 289)

3.8.1 Financial Statements

The statement information is YTD, capturing the period from January to June 2005. Consequently the financial history is limited, and comparative year over year analysis cannot be performed. Confidentiality concerns necessitate that the financials are presented in relative format (percentages).

Figure 6: Genesis Exchange YTD Balance Sheet

Genesis Exchange Corp. Balance Sheet for Fiscal Year 2005 - YTD	
	<u>YTD % of Total A./ L.&E.</u>
Current Assets	
cash and short-term investments	15%
accounts receivable	2%
loans receivable	3%
inventories	
prepaid expenses	1%
Total Current Assets	<u>21%</u>
Plant, Property & Equipment	<u>79%</u>
Total Assets	<u>100%</u>
Current Liabilities	
bank debt and overdraft	3%
accounts payable and accrued liab.	13%
income taxes payable	0%
current portion of long-term debt	
Total Current Liabilities	<u>16%</u>
Long-term Debt	<u>149%</u>
Deferred Income Taxes	<u>0%</u>
Total Liabilities	<u>165%</u>
Shareholder's Equity	
share capital	0%
retained earnings	-65%
currency translation	
Total Shareholder's Equity	<u>-65%</u>
Total Liabilities and Equity	<u>100%</u>

The balance sheet reveals the early stage of the company. Over three-quarters of its assets are in computer hardware and software, essential resources for the development and hosting of the Genesis system. As mentioned earlier, the company has no (material) external debt. The CEO, who is founder and sole owner of the company, holds the company's single common share, nominally worth \$1. The balance of his investment in the company has been structured as a long-term shareholder loan. The company's negative net income (shown below) causes the retained earnings percentage of total liabilities and equity to be negative, and the long-term debt percentage to be greater than 100%.

Figure 7: Genesis Exchange YTD Income Statement

Genesis Exchange Corp. Income Statement for Fiscal Year 2005 - YTD	
	YTD % of Net Income
Revenue	<u>20%</u>
Cost of sales	<u>9%</u>
Gross Income	<u>11%</u>
Expenses	
selling and administrative	113%
depreciation	7%
interest - long-term debt	0%
- other	0%
Total Expenses	<u>120%</u>
Income before Taxes (EBT)	-100%
Income Taxes	<u>0%</u>
Total Income Taxes	<u>0%</u>
Net Income	-100%
Outstanding shares	1
Earnings per share	-100%

Like many start-ups, Genesis is a young, growing firm that has yet to reach profitability; cash outflows currently exceed its inflows. Cost of Sales show higher than will be normal—currently approximately half of revenue—because the high margin from the lower priced and fewer number of issuer subscriptions is out-weighed by the comparatively lower margin seminars and investor presentation road shows. As might be expected, selling and administrative expenses are high—72% is comprised of salaries. (The expenses—mostly development—that were incurred prior to the commencement of company operations do not show on these statements, as another company owned by the CEO incurred them and provided them for a small nominal cost.) While the company hopes to reach break-even on a monthly basis by Fall 2005, it does not forecast to have positive retained earnings for FY05.

There are two useful approaches to using ratios to identify if a company is healthy or sick: compare them to industry averages or look for changes in the ratios over time.³⁸ Unfortunately, the uniqueness of Genesis' broad, virtual and multi-service business model makes it difficult to effectively compare to industry averages, for example to securities brokers. Additionally, there is not sufficient operating history to afford a trend analysis. Therefore, ratios are not presented.

3.8.2 Break Even Analysis

Given that the company is so young, financial projections for two years have been developed for this paper and are presented and analyzed below.³⁹

³⁸ (Higgins, 2004, p. 54)

³⁹ Figures have been adjusted to protect company confidentiality

Figure 8: Genesis Exchange Income Projections

Genesis Exchange

Two Year Income Projections (figures adjusted for confidentiality)

Currency - US\$

Quarter Revenue	2005				2006			
	Q1-05	Q2-05	Q3-05	Q4-05	Q1-06	Q2-06	Q3-06	Q4-06
Issuers Total Revenue	\$3,031	\$10,174	\$21,478	\$79,830	\$226,152	\$669,134	\$914,170	\$1,759,253
Shareholders Total Revenue	\$7	\$7	\$299	\$894	\$2,779	\$8,753	\$26,952	\$69,058
Service Providers Total Revenue	\$14	\$657	\$2,138	\$7,267	\$24,936	\$83,764	\$233,376	\$488,948
Accredited Investors Total Revenue	\$16	\$662	\$1,982	\$6,162	\$19,408	\$59,760	\$153,117	\$293,914
Other Revenue	\$1,048	\$10,891	\$25,755	\$38,087	\$63,315	\$186,146	\$214,829	\$411,167
Total Revenue	\$4,116	\$22,391	\$51,652	\$132,240	\$336,590	\$1,007,557	\$1,542,445	\$3,022,339
Total Variable Costs	\$ 4,272	\$ 5,829	\$ 7,597	\$ 18,370	\$ 34,315	\$ 44,199	\$ 49,966	\$ 60,783
Total Fixed Costs (Non Capitalized Expenses)	\$ 78,560	\$ 100,338	\$ 114,417	\$ 235,224	\$ 402,670	\$ 470,991	\$ 473,015	\$ 619,993
Total Costs (Non Capitalized Expenses)	\$ 82,833	\$ 106,167	\$ 122,014	\$ 253,593	\$ 436,985	\$ 515,190	\$ 522,981	\$ 680,776
Income Before Taxes (EBT)	(\$78,717)	(\$83,776)	(\$70,361)	(\$121,353)	(\$100,395)	\$492,367	\$1,019,464	\$2,341,562
Cumulative Net Income (EBT)	(\$78,717)	(\$162,493)	(\$232,854)	(\$354,207)	(\$454,602)	\$37,765	\$1,057,229	\$3,398,791
Variable Costs as % of Total Revenue	104%	26%	15%	14%	10%	4%	3%	2%
Total # of Issuers	4	14	34	111	318	929	1,616	2,953
Total # of All Customers	18	311	753	2,478	6,907	20,115	41,540	77,304
Total # of All Customers weighted by Rev. Contr.	3	14	38	132	380	1,107	2,489	4,877
VC per Total Wtd Customers (Volume)	\$ 509	\$ 186	\$ 85	\$ 66	\$ 42	\$ 18	\$ 8	\$ 5
FC per Total Wtd Customers (Volume)	\$ 9,302	\$ 3,207	\$ 1,284	\$ 847	\$ 488	\$ 195	\$ 77	\$ 52
All Wtd Customers required to cover Fixed Costs # of Wtd Customers	29	49	72	154	329	377	618	800
Net Overage (Shortage) of Weighted Customers	(26)	(35)	(35)	(22)	51	729	1,871	4,076

The projections are conservatively based only on the current platforms, including offerings, because the trading engine is not forecast to be fully operational until late in 2006. Trading activity is expected to boost revenues and also profits because the variable costs of trading will be extremely small.

Other key assumptions in the modelling include:

- 50% of private companies who register become paying, subscribing issuers
- 5% attrition rate of issuers
- 30% of subscribing issuers will attempt to raise capital in Genesis (indeed this is the primary motivation for subscribing)
- Of an average target raise of \$500,000, only 1/3 of issuers will close their offering, and they'll only raise 1/2 of what they projected.

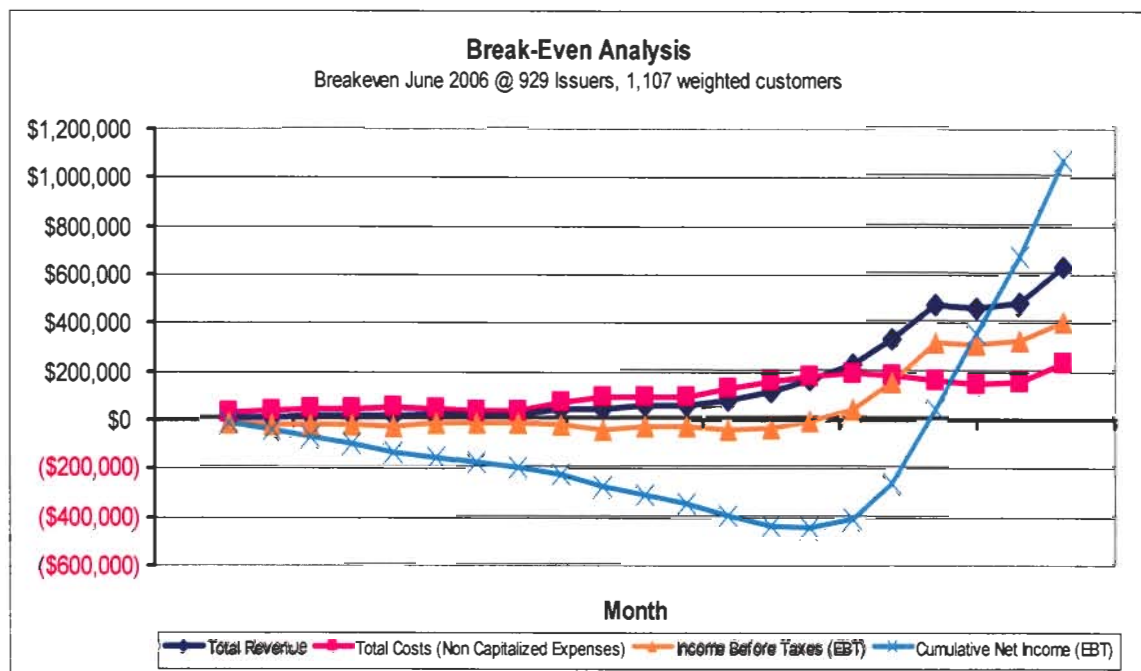
Much of Genesis' projected revenues are generated from issuer activity. The majority of fees are directly issuer-based, but issuers also drive virtually all of the shareholder and 'other revenue', the latter being comprised mostly of seminar, investor presentation and data entry fees. Ancillary services such as special reporting produces most of the shareholder and accredited investor revenue, and service providers also pay a monthly fee to use the Exchange.

As would be expected, variable costs in Genesis' business are small, and as a percentage of most metrics they shrink over time, falling to 2% of revenue and \$5.00 per customer. However they do not become extremely small, because while IT resources contribute a very small portion of variable costs, some of Genesis' services—particularly offerings—require a reasonably high level of touch from staff. Costs are measured based on a weighting of customer volume, where the amount of customer type is multiplied by its percentage of revenue, since shareholders grow to be the largest in number but produce little revenue.

Genesis has managed so far to keep its costs down, as demonstrated by the low volume of customers required to cover its fixed costs. Although it is not currently achieving the number

required to break-even, it forecasts that it will have enough volume to cover fixed costs by the first quarter of 2006, and then enough to cover its variable costs by the second quarter. Q2 of 2006 is therefore also when it projects to have its first profitable quarter, in addition to reaching the break-even point, as revealed in the cumulative net income, (before tax) figures. Cumulative net loss is forecasted to bottom out near \$450,000, which the founder can capably cover. Figure 9 illustrates the break-even graphically.

Figure 9: Genesis Exchange Break-even Projections

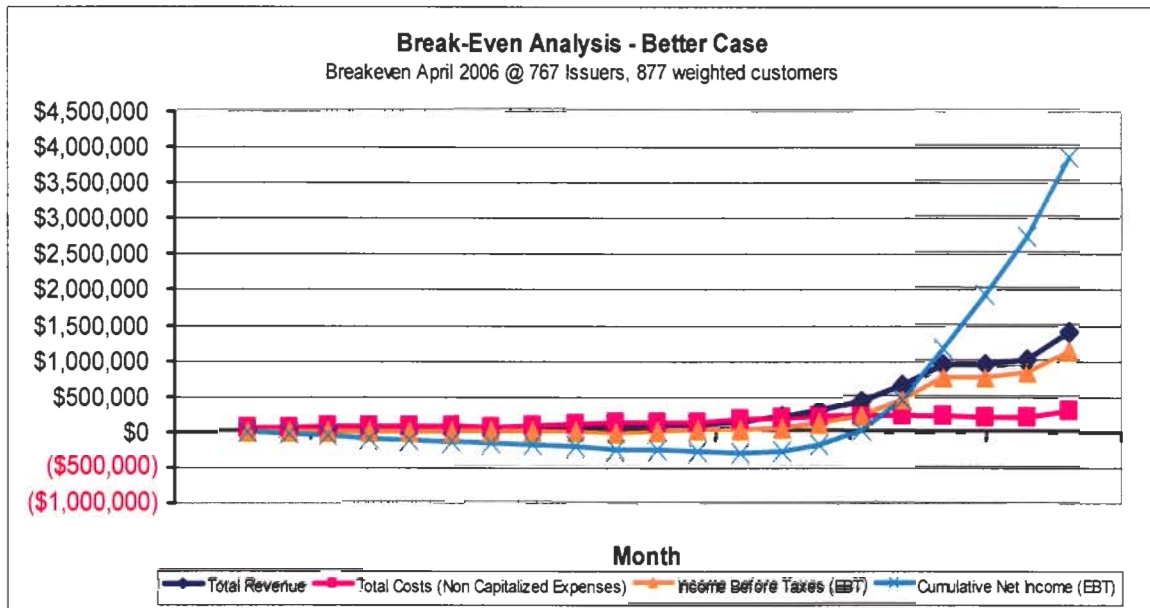


Break-even is reached in June 2006, when the company forecasts that it will have close to 1000 issuers, 16,000 shareholders, 200 service providers and 600 accredited investors, or 1100 “weighted” customers. Profitability occurs in early April, as is demonstrated by the revenue line overtaking cost, and the income line becoming positive. Volume is measured by customers at this stage because of the myriad of different revenue-generating services. As is also evident from the

chart, the private capital markets soften during the summer and Christmas, seen as a flattening of the revenue, cost and income curves.

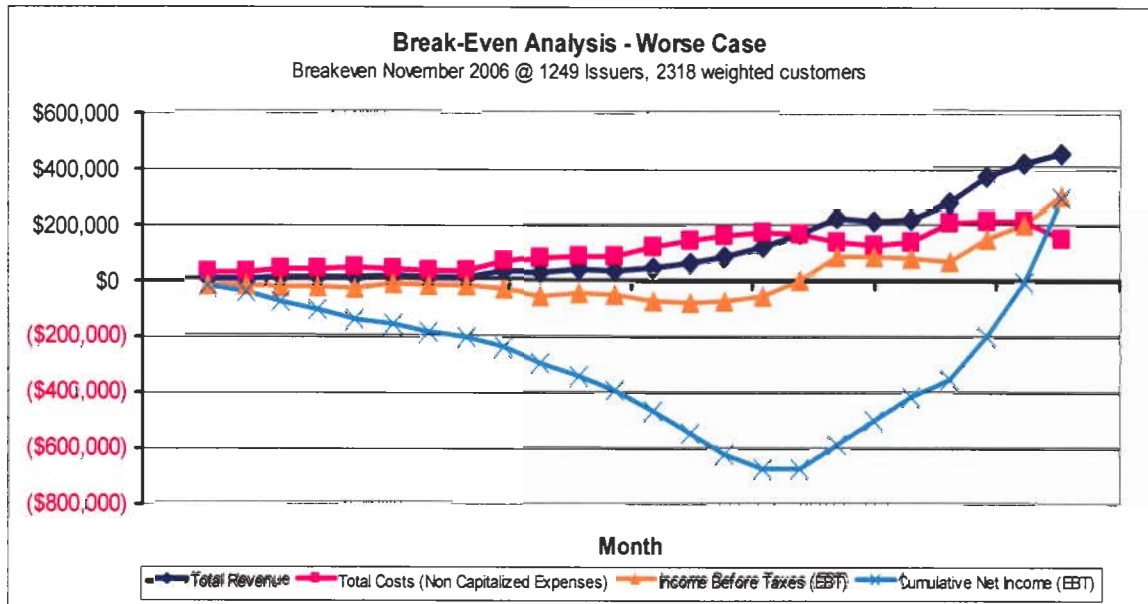
Of the various assumptions used by the company and this paper in the production of the projections, the most sensitive is the growth rate of issuer customers. If the forecast growth rate is low by 5%, which is compounded month over month, then the company becomes profitable in February and reaches break-even in early April, as shown in Figure 10.

Figure 10: Genesis Exchange Break-even Projections – Better



However, if the forecast compounding growth rate is optimistically high by 5%, then after monthly compounding, profitability does not occur until May and break-even is pushed back to late November 2006, as illustrated in Figure 11.

Figure 11: Genesis Exchange Break-even Projections – Worse



In this worse (not worst) case, cumulative net loss is projected to hit \$675,000, which the founder is still able to support financially without requiring external financing. However, even with the conservative assumptions built into the foundation of the company’s projections, the possibility certainly exists that the company could perform more poorly than envisaged above. In this case, the founder has the option to seek outside funding, either debt or equity-based, which he has pre-established to be very viable.

4 ISSUES

The preceding examination of Genesis Exchange's business has identified a number of issues facing the firm; those that are key to its future success are reviewed and explored further.

4.1 Customer Acceptance

Genesis Exchange needs early acceptance and adoption. However there are five barriers that it needs to overcome:

1. A lack of awareness and reputation among its target market,
2. Low customer understanding of the process to raise money,
3. Technology fear and unfamiliarity,
4. The current lack of market liquidity,
5. An unproven business model.

The company's target market of small, high-growth, start-up or early stage BC companies has very little knowledge of Genesis Exchange. Marketing efforts have been minimal, as well the company has intentionally wanted to keep a low profile until it had successfully "triated" its service to the point of putting several issuers through the offering process. At this time, its community of financial service providers is small and the Exchange is not being promoted adequately.

Further, as a relatively new business, it has neither a reputation nor much history, although its founder is reasonably well known in Vancouver and Seattle angel investment and entrepreneurial circles. Many of its prospective customers not only have to be pitched and informed on how the company's services can benefit them, but also sold on the company itself.

Private equity investing is a reasonably relational activity; this is partly where service providers add value.

As discussed earlier, issuing companies as well as investors typically value their privacy and fear sharing information. Given the critical nature of this data, it must be secure, and so understandably some customers are not comfortable loading their cap table and sensitive company information, including financials and performance metrics, into a system they do not know and with a company they may not yet trust. In fact one of the biggest stumbling blocks for issuing companies will be the psychological hurdle of abandoning traditional paper-based share issuances, in favour of Genesis' entirely digital system.

However, what creates more difficulties for customers, even in this technologically advanced decade, is the virtual delivery of the services over the Internet. Customers face learning curves around the overall financing process as well as the use of the website. Because the business model is new, many customers have difficulty understanding and learning the process. For instance, they need to be educated on how company capital structures work and how private financing is organized and performed. Compounding this, they have to learn the Genesis way of accomplishing these functions. As covered previously, although support is provided by MSRs, because the software does the bulk of the work, customers are for the most part expected to use the system themselves to perform many of the activities. Additionally, even if the issuing company's managers are Internet savvy, typically some of its investor shareholders are not. For instance, Genesis requires that all shareholders confirm and pick up their digital shares, but some have difficulty registering on Genesis, and some do not have email accounts or Internet access.

Initial customer acceptance is also affected by the drawback inherent in a business model that capitalizes on critical mass and liquidity. At this early stage, only a small number of investors and investees are in the exchange, therefore network effects have not yielded their benefits yet,

and so there is less incentive for prospective customers to join and participate. Genesis may not be doing enough to attract early adopters—especially the issuers, who need extra incentive to compensate for the lack of liquidity in the Exchange.

Finally, there is the significant risk of innovation mentioned in Chapter 3—Genesis' business model is also new. A private company and accredited investor marketplace has never been implemented on a computer network. It combines features and services in a way that is unfamiliar to its target market. Loading the company profile and business plan into a system and then eventually trading shares through it is not a traditional experience.

All of these factors contribute to a real risk that customer acceptance could be low, making it difficult to attract and retain issuers and investors. Customer acceptance is undetermined at this stage, and as well, due to the same value of privacy issue stated above, the actual size of the market is also unknown, as revealed in the earlier industry analysis. If Genesis is unable to successfully broker a sufficient level of offerings and trades, issuers will not get the necessary access to capital and investors will not use the exchange. If the Exchange cannot do this, it will not attain critical mass or achieve its vision of a fair, liquid market.

4.2 Threat of Entry

Genesis Exchange has a reasonable exposure to the threat of entry by competitors. Since it is a new company, it has no previous customers prior to launching the Exchange. An existing competitor within Canada could leverage its existing customers, capabilities (e.g. marketing), distribution channels or data that Genesis does not yet possess and quickly become a significant threat if not a dominant player. Offering valuable related products or services such as held by investment banks or brokers could be key in mounting a successful attack on Genesis. As well, the company's patents may not be approved or may not be strong enough to deter competition.

However, as mentioned above, the model is new and the threat of entry at this early stage was ranked as only “moderate”. In fact, the threat of entry into Genesis’ specific business from competitors could well be higher than this if the model shows signs of success. Moreover, there may be room for only one private equities exchange in Canada, assuming the need to establish critical mass to be successful and achieve liquidity. If critical mass were necessary, then the advantage of moving first would be absolutely crucial.

Competitive situations that provide favourable conditions for FMA include: where the ratio of minimum efficient size of a firm to the market size is small (only room for the first mover), the markets have standards, the market has network externalities such that the first to critical mass will win the market, or a patent or innovation race exists.⁴⁰ While the last two conditions may be possible factors, Genesis’ model is too new and unproven and the pay-offs are still too uncertain to accurately predict the degree and strength of a FMA advantage.

On the other hand, FMA could be limited by various factors or may not exist at all. A competitor could appropriate the advantage through imitation due to the relatively available and inexpensive input technologies, or by using other elements discussed above. Genesis may not be capable of occupying the entire market, especially if it is expanded to include the US. Additionally, while there are significant switching costs for issuers, there are little if any for the investors, who are important and necessary players. If a competitor can start out with or quickly build a large volume of investors, it might be able to attract investees (issuers), including Genesis Exchange’s, relatively quickly. Furthermore, if Genesis has moved too early or if adoption is slower than planned, Genesis would not benefit from potential first mover advantages and this would also allow other entrants more time to compete. This could in turn allow competitors to improve on the model and possess a “second mover” advantage.

⁴⁰ (Shapiro, 2003, p. 57)

As the industry analysis of Chapter 2 explained, there is also an ongoing threat from existing substitute financing products and services that is rated as “moderate to high”. However, it is arguably not a key strategic issue for the company, since the company is a broker and has minimal control over the substitute products. Moreover, the 1 to 20 billion-dollar size of the Canadian angel investment industry alone is large enough such that Genesis need just focus on penetrating this market.

4.3 Capabilities and Core Competencies

The value chain examination identified which activities Genesis has its capabilities in — both proven and unproven. Genesis has proven capabilities in the majority of its support activities but it currently demonstrates established capabilities in only about half of its primary activities. When it comes to the more important core competencies that are critical in the development of competitive advantage, Genesis has not yet developed any in its primary activities. Its core competency at present lies just in one of its support activities: technology—specifically product development, design and programming.

To the degree that Genesis’ competitors do not have or cannot feasibly acquire Genesis’ technology development competency, its skills provide some degree of competitive advantage. Certainly these technology activities are a key building block of its business strategy and an important component in capabilities-based competition. However in both cases, these core competencies are fragile in that they are dependent on people and so not necessarily sustainable.

A company should derive its competitive advantage from its primary activities, particularly in the Operations area where it “produces” its good or service and thus adds the majority of its value. This is especially true and concerning for Genesis, because it is pursuing a customer value proposition strategy of “Operational Excellence”! The high-level elements of value that Genesis seeks to provide to its target market of private companies and/or investors in

using the Exchange are: (a) access to larger pools of capital; (b) liquidity or diversification for shareholders and founders; (c) fast and predictable capital formation; and (d) reduced capital management costs. To be able to deliver this, the company relies heavily on its Operations activities.

Among Genesis' operations activities, the exchange and management of information, offerings, trading, financial transactions and market participants are critical to the firm's differentiation strategy. These are not only activities that are performed for the target market in a manner unique to Genesis' business model, but they are central to how the firm creates value in the industry chain.

In fact, the latter three are still unproven activities, which adds additional risk. Having half of them as outsourced or unproven capabilities leaves Genesis open to executing poorly on its business plan and losing customers. The company may have difficulty delivering a high quality of technology and personal member service. As a result, opportunistic competitors with a similar or traditional business model may be able to steal customers from Genesis or prevent their existing customers from defecting.

An important ingredient for these activities is the firm's internal knowledge; not only explicit know-how, but also tacit knowledge that is imbedded in its people. Experience and expertise of financial markets is essential for high quality delivery of these activities. Currently the company's knowledge assets are strong in many areas but weaker in the operational activities.

4.4 Resource Constraints

The fragmentation of the industry—specifically the investees and investors—is a double-edged sword. While it means that there is opportunity for a firm that can consolidate it, it also portends difficulties due to the size of the task. Gaining customer acceptance requires accessing

this market, which for Genesis will put pressure on various constrained resources—particularly money and time. The founder has been financing the company partly with profits from another firm, however the Genesis business has now grown more quickly than the other, to the point where this is not enough to fund the daily operations.

Related to the issue of capabilities is the amount of activities that Genesis is outsourcing. An examination of its firm level value chain reveals that the company is performing most of the identified activities in-house. For a company that is still young, has high goals and intends to minimize fixed staffing, there are not many activities that it plans to have performed by third parties. The company may be unrealistic in thinking that it will be able to perform so many of these functions given the resources it has—essentially biting off more than it can chew.

4.5 Regulatory Risk

The factors identified in the threat of entry discussion highlighted that the regulation within the securities industry had a dampening affect on competition. These regulatory forces naturally also represent a risk for Genesis. Although a change in regulations that is out of Genesis' control is not expected to create a serious threat to its strategy, the approvals themselves, and more specifically the necessity to stay in compliance with them poses a hazard to Genesis. The company must adequately monitor and regulate trading activity such that it can prevent a serious breach of its privacy controls or unscrupulous and unlawful conduct on the exchange. If such an event were to take place, its business could be harmed in a number of ways. The Securities Commission could penalize Genesis depending on the severity of the infraction, monetarily or through regulatory restrictions, to the point of closing the business.

As well, this could result in irreparable damage to the company's reputation, causing it to lose customers, or worse. In fact, in an industry where security and integrity are vital, and fraud in

the public markets consumes headlines, Genesis currently lacks any “gold” seal of trustworthiness. A solid reputation was noted as one of the key success factors in this industry.

Additionally, because the regulatory environment is fragmented, with each Province having its own law and securities exchange, the company is faced with having to secure separate approvals. The inability to obtain a blanket market approval creates not only additional risk for the company’s business plan if they cannot obtain exemptions from essential jurisdictions, but also opportunity for competitors to enter them ahead of Genesis.

4.6 Marketing Strategy

Genesis Exchange’s marketing strategy is not aligned with that of a classic Differentiator. It is adopting a “push through the service provider community and client base” approach rather than trying to pull the customers directly. The company may not succeed in bringing in the targeted numbers of issuers and investors.

A push strategy generally relies on the efforts of intermediaries—outside parties. Genesis uses the community of service providers, advisors and networks to which a prospective customer would normally turn. However, presently this community within Genesis is small, and to a large degree Genesis hasn’t promoted to those service providers not yet involved with the Exchange. Further, these intermediaries are not strongly incented to bring customers into Genesis at this time. There is not a good base of investors and investees in the Exchange that will improve demand, and the likelihood of their clients closing an offering or finding the right investment will be lower than in the future. Service providers might only benefit from some extra billing for time spent using the Genesis tools on behalf of their clients. Even if this community is adequately incented and remunerated, Genesis has less control over performance and therefore results.

Most importantly, as mentioned earlier, sticking solely to this approach probably does not make sense for the company in the medium term, because it has to build critical mass. As well, if it hopes to gain any kind of first mover advantage it cannot rely on outsiders; it must put intense efforts into attracting new issuers and investors, quickly. If the model shows signs of success, competitors might be afforded too much of an opportunity to build their businesses at Genesis' expense.

A final issue is that a push strategy is effective when the product benefits are well understood.⁴¹ However, because Genesis Exchange is such a unique business model, prospective customers frequently require a lengthy explanation.

⁴¹ (Kotler, 2003, p. 511)

5 RECOMMENDATIONS

5.1 Customer Acceptance

Genesis Exchange needs early acceptance and adoption and so must overcome the five barriers identified above—a lack of awareness and reputation among its target market, an unproven business model, low customer understanding of the process to raise money, technology fear and unfamiliarity, and the current lack of market liquidity.

The obvious means of overcoming the awareness problem is through improving its marketing activities. As previously mentioned, Genesis has adopted a push strategy for a variety of reasons, including cost-effectiveness, due to its limited financial resources. Because its community of financial service providers is small and so the Exchange is not being promoted widely, it needs to devote resources to increasing the number of providers and the amount of communication and promotion. This will be covered further in the Marketing recommendations below. It should be noted that the trialling of its offering service has just been completed, which removes one internal marketing barrier.

Genesis needs to increase its customers' comfort with the Exchange. Likely its best approach is to leverage the reputation of its service provider “distributors” who are industry professionals and have the trust and relationships built with their clients, as pointed in the discussion of issues. This underscores the importance of an effective push marketing strategy. Currently the reputational capital that Genesis has lies in its founder; public relations activities discussed below can help it better capitalize on this.

Genesis also needs to build its own reputation, not only to alleviate prospective customer concerns about trust, but also to build its community. EBay has clearly demonstrated that community is a critical component of building liquidity in a marketplace. As stated previously, Genesis has a “100% reference-able clients” strategy; it aims to create passionate customers who will not only evangelize to others in their local industry community, but will also “write the advertising message” needed for Genesis to communicate to other prospects. Indeed, Genesis is receiving very strong, positive feedback from its initial customers. However it has no initiative in place at this time and so should initiate a formal customer feedback program. This will not only ensure the collection and reinforcement of positive responses, but also give the company valuable information on how to improve its services. Among the many possible options, the company might in particular evaluate the implementation of online surveys, customer telephone and in-person interviews, and the creation of a customer council. Issuers, shareholders, investors and service providers should all be included.

While the above recommendation will help the company build its reputation, naturally the ultimate creation of it must come as a result of those positive experiences, such as successful financing raised through closed offerings, increased investor visibility into more deals, well-placed, strategically-fitted investments, and increased business for service providers. Unfortunately this will take time for the company to earn.

Increasing customer adoption clearly involves reducing customer risk, or perceived risk. Therefore, Genesis could create a “signal” of the Exchange’s quality or low risk, much like many consumer products and services producers who launch new products on the market. For instance, it could offer some form of guarantee. However at this early stage with fewer exchange participants it is harder to close deals, so the guarantee would have to be carefully chosen. Rather than based on a final financing outcome, it would have to be on a more controllable output, such as the amount of time to create an offering, or the number of markets the offering would be

exposed to. Alternatively the company could provide a “satisfaction or money refunded” policy for various system features or stages in the money-raising process. This would pose less risk to Genesis but could still be attractive to issuers.

Two other related barriers for customer acceptance are the customers’ lack of knowledge of good corporate governance and how the financing process works, as well as the fear of technology and unfamiliarity with using an online or computer-based system. The Exchange is largely built to be a “self-serve” system. While Genesis wants the issuer’s service providers, e.g. law firms, to use the system on behalf of their clients, it knows that many companies—often those with strongly-entrepreneurial CEOs or constrained financial resources—will endeavour to do it themselves. Therefore Genesis must provide the customers with the knowledge and skills they need to understand and use the system, and it can do so in a variety of ways. In fact, the aforementioned customer feedback program can provide the company with additional valuable information on how to make the system user-friendlier.

It must make the web system itself easier to use; for instance various pages contain features that are not intuitive for customers. More “help” features must be built in so that at any point in the system the customer can obtain contextually related information. Online self-guided multi-media tutorials would aid customers in using the various major components of the Exchange. Genesis has already designed a classroom style hands-on user-training seminar for issuers, especially those who find the Internet and computers more challenging. But for those who are not able to attend in person, teleconferences and webinars—seminars conducted by web conferencing—would help provide more individualized support. These educational aids can teach the basics of raising capital as well as using the web system. Genesis has the opportunity to earn revenue from some of these services, e.g. the classroom seminars and web conferences.

In general though, it is more efficient for Genesis to leverage its network of service providers. It is more efficient for companies with complex capital structures and offerings as well as for those who need extensive personalized assistance, and it also reduces the burden on Genesis' limited resources.

Finally, with respect to the process and the system, the need for community makes the existing customers very important and by extension, the customer experience. Genesis must ensure that all the customer contact points—the specific services that touch the clients, both personal and technological—are supportive, effective and user-friendly.

Genesis must also explore how it can compensate early adopters—especially the issuers—for the reduced benefits and liquidity that the new Exchange currently provides. One strategy would be to provide extra incentives. Genesis' pricing is already low compared to the existing market options, so for many target customers, there is little to be gained by lowering them further. In fact, the experience of other product and service markets has shown that quite often lowered pricing is not required to induce early adopters to buy in. There do not appear to be many options here.

Nevertheless the outside strategy-consulting firm mentioned earlier had identified several different industry segments that have greater difficulty in raising money and might respond favourably to special inducements. As an example, some industries fall out of favour with the general investment community; for instance when alternative energy and biotechnology companies might be “hot”, an industrial goods company may not. Similarly, seasonality is a factor. In general, it is harder to raise money in the summer and around Christmas time. Additionally, some specific industries have their own independent cycles of activity. If Genesis was able to position itself as a credible and cost-effective alternative, customers might join the market with moderate inducements when they otherwise might not have.

It is worth noting that taking this same idea in the reverse direction, Genesis could explore price discrimination schemes to increase profitability. Being a digital market makes it easier to employ different types of pricing mechanisms that are based on the customer's willingness to pay as opposed to being based on the costs of providing the service. It is also a viable option because arbitrage is not possible—customers cannot buy the service cheaply and then resell it to others at a premium. Identifying applicable customers can be easier if the seller can induce them to reveal their willingness to pay (second degree discrimination), but as well, Genesis should be able through its systems to identify some of those customers with a higher willingness (third degree). For instance, inevitably some companies whose industry is not currently in demand wind up in a financial crunch and cannot stretch their existing funding to the “best” time for them to raise money. Pricing according to willingness to pay would also allow Genesis to charge different prices, e.g. during the busy season or for easily funded industries.

There may be other effective pricing “tools” to increase early adoption. Genesis could bundle different services, such as an ancillary service with one that is core. This could induce customers to purchase services they otherwise might not, such as an extended six-month issuer subscription combined with a discounted seminar or free hours of data entry. More importantly, bundling can serve to move issuer customers more quickly to listing on the Exchange.

To date Genesis has focused its sales and marketing resources on bringing in issuers because they bring in investors automatically when they load their capital structures—their existing shareholders are required to register and confirm their share holdings. On the other hand, several of the offerings pricing mechanisms are configurable as auctions. This means that the Exchange is going to need to maximize the number of bidders sooner than later, so it should increase its recruiting of accredited investors. One strategy would be to focus first on bringing in key, high profile, active-in-the-community accredited investors from angel networks. Seeding the

Exchange's investor community in this way would speed investor adoption since these individuals network heavily with other investors.

The risk of innovation is a more inherent and intangible acceptance risk than those covered above. As a result, it is more difficult for Genesis to directly address this vulnerability. However the above recommendations for addressing customer adoption will help substantially in mitigating this danger. Genesis will know that it has come a long way in addressing these risks and concerns when strong percentages of customers are willingly converting solely to electronic filings and shares.

5.2 Threat of Entry

Genesis Exchange needs to take action to reduce its exposure to the threat of entry by competitors, especially if its model proves successful. There are a number of strategies it can employ.

To the degree that first mover advantage may be possible, Genesis should develop appropriate plans because it is the first private stock market in Canada. To be effective, a FMA must "generate an asset or competency that competitors are unable to duplicate or counter. A sustainable FMA can result from technological leadership, pre-emption of assets, and/or customer's switching costs."⁴²

In order to build and maintain a dominant position Genesis should indeed strive to build the highest possible switching costs and lock-in for its customers. Currently, the time and effort required by issuers to list on the Exchange does represent a significant customer setup cost. Short of eventually reaching liquidity though, there are fewer options for inducing investors to stay with Genesis. After all, investor diversification is a popular and wise investment strategy. Investors

⁴² (Aaker, 2001, p. 183)

would be less likely to switch however, if Genesis offered diversity of investments, for instance, issuing companies in a broad array of industries and markets. Another attraction, especially for angel investors, would be the active involvement of influential investor networks in Genesis. Even a basic strategy of designing the system and its features such that customers are induced to use the site regularly (e.g. daily), aka “stickiness”, can create buyer inertia due to habit formation. As well, if successfully delivered, Genesis’ value proposition of “Operational Excellence” may help cause buyer inertia due to uncertainty over other competitors’ quality. As hinted above though, establishing network effects is the best form of creating switching costs. Users become loathe to switch because they lose more than they gain.

Just as auctions require the aggregation of buyers and sellers in order to increase competition and benefit both groups, similarly aggregating content can add to (the exchange’s) power in knowledge and information markets.⁴³ It can also be a good defence against the threat of entry, so Genesis should consider adding static and dynamic content, owned by itself as well as provided by its service provider and angel investor community. In this way, Genesis may be able to prevail over its offline competitors by capitalizing on the unique emarket characteristic that enables buyers and sellers to acquire more, better and faster information with lower search costs.

Pre-emption of assets is not a viable option for Genesis, given its young age and limited resources. However another textbook alternative to diffuse a market entry threat is to signal and develop some form of credible commitment to a competitive strategy. It ideally is irreversible and presents rivals with a difficult battle for market share, or better, a fait accompli that reduces their options. In both cases Genesis does not have the power to implement these strategies on its own, but it could potentially do so through a partnership.

⁴³ (Shapiro, 2003, p. 7)

To combat the power of existing market players who might wish to enter Genesis' space and leverage their strengths, Genesis could partner with an existing player that has complementary assets and strengths. In the US, Entrex has done this by partnering with a brokerage firm. This partnership could take many forms, from a strategic marketing agreement right up to a joint venture or licensing agreement. A suitable partner would likely have existing issuer and investor customers as well as distribution channels across the country that could feed into the Genesis system.

Another benefit that can sometimes accrue to first movers is a cost advantage. Internet technologies tend to reduce variable costs and tilt cost structures toward fixed costs, creating significantly greater pressure for companies to engage in destructive price competition.⁴⁴ However, this is a double-edged sword. These technologies might provide Genesis with an absolute cost advantage if it has lower fixed cost than most other potential competitors. In an effort to fight off competitors it could theoretically afford to charge a lower price by needing less revenue to cover fixed costs. But a competitor with higher fixed costs could likely have deeper pockets, and thus afford to incur losses on this business in order to capture market share. Clearly, Genesis needs to avoid destructive price competition if another exchange surfaces, and instead pursue other ways to attract and retain customers.

Finally, employing technological leadership as a strategy to thwart competitors may be ineffective. As discussed in Chapter 2, the nature of computer technology and particularly Internet applications makes it more difficult to sustain technological advantages, due to the openness of the Internet and advances in software. This makes strategic positioning all the more important.⁴⁵

⁴⁴ (Ibid. p.4)

⁴⁵ (Porter, 2001, p. 10)

Indeed, the foundation of Genesis Exchange's defence against competitors lies in its ability to differentiate. It needs to leverage its innovation, technology strengths and highly skilled, flexible labour force to create and secure a controlling market share of the fragmented, private small and medium sized companies seeking capital.

Accordingly, it should use its IT competencies to develop harder-to-duplicate and ideally proprietary technology. It could build on and around its existing patents, or develop new patentable ideas. As well, it could focus on creating additional innovation around existing system processes, such as the corporate governance methodologies. These have been adapted from the public markets, and Genesis could give them some additional unique functionality. The CEO and the development team have the ability to develop proprietary technologies; they have also done it in previous companies.

Ultimately though, becoming a true exchange and providing a measure of liquidity to market participants will be the most critical differentiating factor. It would not only attract customers from traditional competitors but also keep them from going to any other private equities exchange.

5.3 Capabilities and Core Competencies

Clearly, Genesis needs to increase its number of proven operations capabilities. Of course, a chief reason that so many are unproven is that the company is very young. Regardless, operations activities are crucial to the success of any firm, and especially to Genesis, given its "Operational Excellence" value proposition. The critical unproven capabilities as shown in the value chain are: offerings and trading management, financial transaction management, and compliance monitoring and enforcement.

Genesis can obtain more proven capabilities through either internal or external means. It can develop them internally over time through experience in the business, but this would be slow and would subject the business to undue risk and problems through poor performance. Alternatively it could investigate the feasibility of providing education for its members; there are firms that specialize in financial services training.

Subject to resource limitations, it may be more effective for Genesis to procure these talents from outside the firm, if not immediately then as it fills its staffing requirements. If so, given the critical unproven capabilities listed above, it would be beneficial to seek out experienced and skilled staff and/or management who have worked in operations capacities at a Canadian stock exchange, investment dealer or brokerage house. In fact, Porter advocates that deep industry knowledge is necessary for an Internet-based company, to allow proprietary skills, information, and relationships to be established.⁴⁶ The other external option noted earlier, would be to partner, in this case with a dealer or brokerage, particularly one that specializes in private placements.

Further, the exploration of key issues highlights the company's need to develop additional core competencies; if not in its operations area then at least in its primary activities. While the present technology competency is valuable, it is dependent on just several people and so not necessarily sustainable. Core competencies should incorporate business processes as well as skills. The company should pursue two routes to rectify this problem. First off, it should build out its technology team to provide a measure of redundancy in case key staff is lost. More importantly, it should leverage the additional technology recommended in the threat of entry section to build additional business processes around which it can develop proficiency and ultimately core competencies. The corporate governance practices are a good example, where Genesis could excel at introducing them into the private equity market. In order to accomplish

⁴⁶ (Ibid. p. 17)

this in a timely manner the firm would likely need to hire additional IT staff anyway, just to handle more of the day-to-day programming and software maintenance tasks. However it would be advantageous if the firm could augment this effort with knowledge imported from a key hire from within the financial markets industry.

Besides processes, it should develop additional core competencies within its primary activities' skills. It can apply the strategies noted above for evolving its unproven capabilities towards its proven capabilities, and develop and build them into core competencies. For instance, the CEO has proven capabilities in building business through networking in industry communities. If the company were to hire more people with these base skills and train and introduce them into specific markets, this could become a core competency leading to a competitive advantage making it difficult for competitors to gain a foothold in those markets.

Of course, the development of core competencies requires experience and time, so the company should make this a priority. Given these concerns, Genesis should re-evaluate its operational plans against its strategy. Otherwise, it may find that a competitor capitalizes on these weaknesses and seizes the opportunity to take Genesis' customers.

5.4 Resource Constraints

As noted earlier, the market is large and fragmented, yet the company—already resource constrained—is planning to tackle it with mostly in-house resources. Genesis should carefully review its value chain with a view to temporarily or permanently outsourcing more activities, focusing on those that would not ever be expected to become part of its competitive advantage. This could also help the firm move more quickly to achieving operational excellence. Speed is important for getting to critical mass and possibly attaining a real first mover advantage.

Some of the marketing activities, especially those shown as unproven capabilities, lend themselves well to outsourcing. Public relations through an advertising or niche-marketing firm can be reasonably cost-effective if done intelligently. As well, there are numerous firms that provide customer survey, opt-in marketing and promotion response tracking services. In fact, existing technology can be connected to Genesis' systems and run as licensed software or purchased through an ASP.

While Genesis should look to see if there are activities that it can outsource, at least in the near-term, it should be mindful of creating vendors who could specialize and supply its competitors as well. "As competitors turn to the same vendors, purchased inputs become more homogeneous, eroding company distinctiveness and increasing price competition. Outsourcing can actually lower barriers to entry because a new entrant need only assemble purchased inputs rather than build its own capabilities".⁴⁷ For this reason, its outsourced activities should be as generic and market-independent as possible—PR is a good example.

Alternatively, especially for more sensitive activities, Genesis could mitigate this concern by turning work over to a contracted partner, thereby relieving it of the burden of performing the task yet protecting any potential future strategic or competitive advantage gained from the task's competence.

On the other hand, it can be argued that a firm with a differentiation strategy needs a higher degree of control to execute that strategy. Genesis' preferred plan to achieve that control through this low-outsourcing approach does align with its reasonably broad vertical scope across the industry chain and its intention to eventually expand its reach geographically outside Canada. Nonetheless, Genesis should consider re-examining its outsourcing strategy, including partnering strategies if it wishes to retain more control over particular activities.

⁴⁷ (Ibid. p. 8)

Finally, it has been noted that Genesis has limited financial resources, for instance it is a prime reason for using a push marketing strategy. Every firm obviously has a limit to its resources, and Genesis is constrained in comparison to many existing firms in the private capital market. However, as the financial inspection revealed, the company founder has the resources to finance the firm through to break-even sometime in 2006, and to some degree further if performance is less than projections. This being the case, it is recommended that the founder consider injecting more cash into the company at this stage. This would allow it to implement some of the recommendations in a more timely manner, and as has been noted, if the model proves successful, time may well be of the essence!

5.5 Regulatory Risk

Unquestionably the regulatory forces in the capital and financial markets represent a risk for Genesis as well as potential competitors and the industry at large. Compliance with regulations and the arduous task to attain Provincial approvals are the main issues for Genesis.

Genesis must ensure it builds in adequate systems to catch unlawful conduct on its Exchange, especially when trading systems become operational. These systems must be embedded in the software, as well as built into procedures that are followed by company personnel. The previously noted recommendation of hiring an individual with stock exchange experience could yield additional benefits here, since knowledge of non-compliant actions and the techniques underlying unscrupulous behaviour could likely be better detected. The company should have an audit done by a third party to test its own internal governance disciplines and systems for compliance to regulations. In fact, the CEO has a good relationship with the BC Securities Commission and may be able to get invaluable and potentially very economical assistance if not advice in this area.

From a reputational standpoint, the company shouldn't wait too long before engaging in crisis management planning, which a PR firm could assist with. Having a plan in place would not only help it in the event of an emergency, but it would aid in brainstorming other gaps and corresponding solutions. Genesis cannot manufacture a "gold seal" of trustworthiness quickly, but there are things it can do to improve its reputation in this area. It can adopt higher-level standards, get "certified" for adherence to them, (for example by one of the Big Four accounting firms), and then advertise the fact. Possible sources of standards include the US Securities Exchange Commission or even ISO 9000, a set of worldwide standards that establishes requirements for companies' quality management systems. On a lesser scale, the company could investigate and adopt recognized best practices for its industry, and promote this to its customers.

There is little that Genesis can do directly to mitigate the issue of having to secure separate approvals from jurisdictions in Canada. However it can take action indirectly, by adopting strategies previously discussed to reduce the threat of earlier entry into other Provinces by competitors. It is worth noting though that this is likely less an issue in the US market should Genesis expand; although each state has its own body of securities law and regulation, many of them adopt the common federal regulations.

5.6 Marketing Strategy

Although Genesis Exchange's push marketing strategy is not aligned with that of a classic Differentiator, it may not make sense for the company to try to "improve" this strategic fit variable at this point in time, especially since financial resources are presently somewhat limited. If it works for the company, and allows it to build its business on or above plan, it may be difficult to justify a more high-cost approach, at least in the short term.

Regardless, Genesis must increase customer awareness by maximizing its present effort, which is predominantly through the service provider community. The company has been keeping

a low profile, wanting to release its offering platform first and get a few completed offerings under its belt. Consequently, the push strategy is mostly generated through the relationships that the CEO has within his network of contacts and associations of high technology entrepreneurs, which the service provider community sponsors. The first initial offerings have just been released, and so the company should begin to plan and expand its marketing efforts.

Genesis needs to rapidly acquire more service providers. It should communicate directly with the entire prospective service provider industry within BC, which, being relatively small provides cost-effective leverage into the larger, issuer target market. Some of the options include advertising in appropriate trade journals, participating in industry events such as legal or accounting conferences, or conducting telesales campaigns.

To increase customer awareness though, it must provide sufficient incentive to the service providers such that they will make their clients aware. Genesis could offer “reseller” discounts on selected fees, which would allow them to make some extra margin. It could offer them exclusivity in certain services or market subsets. It should also reward them for referrals, for instance compensating them according to the volume of business they sign up, whether it is issuers or investors or even more service providers.

Of course the company’s “100% reference-able client” goal extends the push strategy to issuers and investors. They need to also be included any referral campaign. Genesis needs these prospects to make the decision to participate in the system now, so it could experiment with running these incentives as “limited time” offers.

To not only be able to compensate referrers appropriately, but also spend its marketing dollars effectively, the company should undertake a customer lifetime value (CLV) analysis. This assesses the approximate total profit stream from each customer over the lifetime of their relationship with the company. This first involves segmenting customers based on their similar

characteristics. Taking customer responsiveness into account, the company would then compute the average margin made, the cost of marketing to the customer, and the probability and length of time that the customer would generate revenues. Future revenue is discounted using a net present value calculation. From this the total cumulative expected profits from the customer, net of acquisition costs, could be calculated. Although Genesis has limited operating history and revenue, it may be able to generate a usable estimate that can be revised over time. Understanding the potential value of customers would allow Genesis to devise optimal strategies for each customer as well as eliminate wasteful costs. “The ultimate goal is to develop highly committed customers who not only...generate continual revenue streams, but also require minimal maintenance”.⁴⁸

Genesis can also benefit from forming alliances with key players in the private markets. For instance, some of the new BC-based investment funds that focus on the private equities markets, like the BC Advantage Fund, would provide ideal cross-marketing opportunities. Both organizations are looking to attract investors as well as private companies seeking capital. These and other government-sponsored funds provide unique incentives for the investors, such as tax-deductible eligibility for investments.

If the “push through the service provider community and client base” approach fails, then Genesis will have to consider a pull strategy in the near future. The company should not wait until it has little choice, but rather begin planning for it once solid results of the present strategy are known. A pull approach can also combat the problem of Genesis’ benefits not being well understood and the resulting difficulty for the service provider community to sell them. An effective advertising and communication campaign should inform, educate and persuade Genesis’ target market.

⁴⁸ (Ofek, 2002, p. 1)

A pull approach can also be more effective in bringing in investors. To date, the company's primary method of bringing investors into the Exchange is passive—through existing shareholders registering to pick up their now-digital shares or by being referred by other Exchange participants. However as identified earlier in the customer adoption discussion, Genesis needs more investors, and accredited high net worth investors in particular will attract issuers. Fortunately, Genesis' online environment holds the potential to cost-effectively acquire customers from the fragmented investor community. Viral marketing methods can work well on the Internet, and will help the company with both its push and pull strategy, especially during this time of limited financial resources. Investors typically know other investors, so Genesis should induce them to invite others to join, for instance through an appropriate contest such as a chance to win free professional services, with extra "contest entries" for providing additional investor email addresses. In addition, Genesis should seek permission to market to all the shareholders that the issuers load into the system.

As a digital marketplace, Genesis has the opportunity to capitalize on potentially powerful, cost-effective ways of marketing to its customers, as illustrated above with CLV. Powerful databases and electronic networks now allow companies to collect concise information about customers and their buying patterns more effectively and efficiently than ever before.⁴⁹ The Internet in particular increases the ability of firms to track the behaviour of individual customers. Although it can be challenging to manage such vast amounts of data, Genesis needs to explore how it can best utilize this information in its marketing plans. For instance, it can tailor its communications and promote offers to targeted subsets of its issuers, investors and service providers. It should ensure that its data structure is set up now so as to more easily incorporate data mining processes as the Exchange grows.

⁴⁹ (Ibid. p. 1)

In addition to online marketing to investors, Genesis has a unique opportunity to create a needed but absent community in Canada. Although networks exist for angels, there is nothing in place for the larger and possibly more in-need population of accredited investors. Offering an investor newsletter focused on private company investment combined with a discussion forum hosted by experienced, successful accredited investors would be one way to start building this community.

Genesis needs to incorporate its positive customer feedback into its marketing efforts. Real customer quotes make valuable proofs and are among the best form of advertising that a company can have because it is not the company talking. This also helps increase the company's good reputation. In fact, the previously mentioned strategy-consulting firm proposed a branding strategy that included the telling of (customer) stories, and the talking of the Exchange as part of an experience, adventure or dream. In this way it could also build curiosity and intimacy into the company's reputation and brand.

Genesis should also capitalize on the opportunity to create a unique brand, since there is no other private stock market in Canada. For instance it can position itself as 'the' national resource for private equity investing. Advertising, as suggested above, especially when cash flows are established, would help Genesis to develop brand strength. This would not only continue to attract investors and companies but would help to limit entry. In fact from a PR perspective, the company knows it is unique and represents a newsworthy story for the media. With the launch of the offering system the company is nearing the time to come out and begin telling its own story. Therefore it needs to begin creating its PR plan now, before the story gets out without the company being in control of the message. Initially, exposure will increase traffic and inquiries from prospective customers, which will impact many areas of Genesis' primary activities, particularly member services.

Like the PR impacts above, in fact many of the above recommendations require resources—particularly human and financial—that the company does not currently have in place. As the financial analysis and issues examination touched on, there are many factors that can affect the company's performance. If the company were to experience stronger than forecast success, it would be able to implement many of the recommendations in a timely fashion. In fact, it might be advisable to move up the timetable for some of its strategies, given that the founder has the ability to fund the company for approximately two years on standard projections. However, if results were weaker than projected, then the company would be faced with two immediate and obvious courses of action. It could obtain external financing and continue to pursue many of the recommendations above. Alternatively, especially if it was believed that the company's timing was early, it could continue with lower cost growth strategies, and/or seek a strong partner. But regardless of the future outcome, it highlights the need for additional planning now.

6 SUMMARY AND CONCLUSIONS

6.1 Summary

Genesis Exchange's new online private equities marketplace for private companies and investors is an unproven business model. By brokering financings and selling related services in this unique manner, it is endeavouring to meet the deemed needs of a fragmented market.

A Five Forces analysis reveals that the capital markets industry for small and mid-size private firms is reasonably attractive. The company is pursuing a differentiation strategy within the industry, and an assessment against a generic strategic fit chart confirms that it is relatively aligned to a classic Differentiation strategy. An inspection of its financial state and projections shows that the company has a reasonable chance of reaching break-even in 2006 without requiring outside financing, although a moderate change in its key growth assumption could alter this.

Reinforced by an informative analysis of the firm's value chain, a number of key issues were brought to light that face the firm in its first full year of commercial operation. These include: a lack of customer acceptance and adoption, the threat of entry by competitors if the model proves successful, a deficiency of proven capabilities and core competencies, regulatory risks, resource constraints and the need for more marketing.

6.2 Conclusions

Key recommendations for addressing customer acceptance include better leveraging its push marketing strategy, particularly the service provider community, encouraging adoption

through compensating early adopters for the lack of market liquidity, and seeding the exchange with more investors.

Mitigating the threat of entry and capitalizing on any first mover advantage that may develop requires Genesis to increase investor switching costs. Among the ideas offered are to aggregate content, consider increasing its market power by partnering, and to leverage its IT competencies to develop harder-to-duplicate proprietary technology.

Principal suggestions for expanding its proven capabilities and core competencies include adding financial market-experienced staff, developing and become proficient in additional system processes, and focusing on growing its proven capabilities into core skill competencies. Related to this were recommendations to outsource more of its non-core activities to a supplier or a partner, given the firm constraints and need for moving quickly.

Genesis presently has constrained financial resources, however the financial inspection noted that the company founder has the resources to finance the firm through to sometime in 2006. Therefore it is recommended that the founder consider injecting more cash into the company at this stage, allowing it to implement recommendations in a more timely manner.

Suggestions to mitigate regulatory risk include acquiring experience and knowledge to ensure strong compliance processes, building in higher-level best practices or quality standards and having its systems audited. As well, Genesis should develop a crisis management plan.

Among the recommendations for its marketing strategy, acquiring more service providers and increasing all customers' referral incentives were paramount. As well, Genesis should begin planning for an inevitable pull marketing approach as well as leveraging the advantages inherent in its online, digital form. It can employ viral marketing and begin preparing its systems for mining its data to implement online targeted marketing. Additionally, it should begin forming a

needed community for the nation's accredited investors. Finally, with the offering system now released, the company needs to move forward on building its brand and its PR plan.

The "theory of strategic fit" requires that strategy, organizational capabilities and markets are in synch, which then produces the opportunity to create competitive advantages. As Porter advocates, to gain competitive advantage, Internet-based companies like Genesis must bring together virtual and physical activities in unique configurations, involving new, hybrid value chains. As well they should seek out trade-offs, where an Internet-only model offers real advantages, and they should create customer value and charge for it directly.⁵⁰

The above analysis shows that for the most part, Genesis is following this strategy. However, it may only truly possess a defensible and sustainable competitive advantage when it has built a critical mass of issuers and investors and the exchange has achieved liquidity.

⁵⁰ (Porter, 2001, p. 16, 17)

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