

## **Stairways to a bright “Footure”**

### *Freakloset*

It was already half past eight pm and the airplane has not taken off yet. Nobody seemed to care. Passengers kept dragging their trolleys, squeezing the jackets in the cabinets, adjusting their seats and choosing their movies in an impervious turbulence.

Joana was completely indifferent to whatever was happening around her. Massego was playing loud on her earphones while she was flicking through the pages of Vogue. By her side, Diogo stood idly by looking at the window. The two friends have not exchanged any word yet since they stepped into the airplane.

The flight was late and they were counting on an intense working night. In less than 48 hours, their startup was about to give one of the greatest steps so far, something they never expected to happen so early. On the January 8<sup>th</sup> of 2017, Freakloset’s derby shoes and ankle boots were about to step on the catwalk at the London Fashion Week, in the feet of all the SIBLING London models for their AW17 collection show.

Despite the nerves, the two entrepreneurs could not hide the joy and proud they were feeling. More than anything else, this would represent a huge step in their internationalization strategy and a validated appraisal of the quality and design of their products.

On the other hand, *would they be ready to expand the brand globally? Were their products disruptive enough to thrive in such a competitive market and environment? Was their business model solid enough to stand still on a drastic scale? How would they gather the money required to fund it? What would this represent for the Portuguese shoes brand? Would have they made it without the support of APPICAPS?*

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## **NOVA School of Business and Economics**

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This business case is intended solely for teaching purposes. It should not be considered as a source of primary data or depiction of effective or ineffective management.

## Part 1. Brief Overview of the Footwear Industry

### 1.1 Global Outlook

The global footwear market is composed of the revenues generated through the sale of all types of men's, women's and children's shoes spread all over the world. With an identified progressively increase of the fashion's influence in the industry, in 2016, the worldwide footwear production reached again the previous year record of 23 billion pairs of shoes, 3 billion more than what it was producing back in 2010. The solid market share of 87% that Asia has been keeping for the last couple of years is still fed the worlds' leader China, which accounts alone for more than 57%, together with some other important players such as India, Vietnam, Indonesia and Bangladesh [**Exhibit 1**].

On the other hand, a significant contrast is raised when it comes to comparing the footwear exports in terms of value. In fact, from the Top 15 of value exporters, nine of these countries are European and Portugal ranks the 13th place with a total of \$2.129Million, 3,8% share in total country exports, with an impressive growth of 3,2% over 2015<sup>1</sup>.

### 1.2 Portuguese Context

The Portuguese footwear industry that has been seen, not that long time ago, as an obsolete and internally focused small industry, has now become one of the global market references.

Currently, the national footwear industry exports more than 95% of its production, the second highest ratio in the world, to over 150 countries<sup>2</sup>. Europe has been the primary destination of the Portuguese exports whose Top 5 leaders (France, Germany, Netherlands, Spain and UK) account together for over 74% of the total share. It is also relevant to underline the notable progress of America that evolved from 3,9% in 2015 to 5,1% in 2016.

The average price of \$26,1 reflects the degree of appreciation that the Portuguese footwear has earned in international markets and ranks it right after Italy with the second highest average price of the industry's exports [**Exhibit 2**].

This is an extremely positive performance when compared to the overall average exports' price which had a retreat of 2,3% to \$8,8 per pair from 2014 [**Exhibit 3**]. This can be an indicator of the increasing competition of the global industry, which is leading producers to adopt cheaper textile materials that start to replace the traditional leather in favour of lower production costs and a more informal style.

However, the Portuguese footwear is positioned in the medium / high price segment deeply connected to a guarantee of good quality products and a recognized focus on design and innovation. When analysing the manufacturing process, all these can be found mainly concentrated in the North of the country in two hub areas which cover on one side Felgueiras and Guimarães and the other Santa Maria da Feira, Oliveira de Azeméis and São João da Madeira. Here, the industry is mostly composed by small-scale factories that turns it an agile, cheap, and fast process, which allows raw materials such as leather, laces, hides, heels, outsoles, trims and metal components<sup>3</sup> to be imported within a couple of days. These five municipalities employ around 75% of the sector, whose number of employees grew 20% from 2010 to 2016.

### **1.3 Global Trends**

Apart from the two previous trends that slowly started to impact the shoe industry in particular, many other general economic, demographic, social and cultural trends are expected, in a not that distant future, to clearly influence the way shoe consumers behave and eventually bring severe changes to the whole footwear paradigm.

First of all, the growing middle classes in emerging and developing markets is challenging the current patterns of footwear and apparel consumption. The rising income and consequent expenditure of countries such as Brazil, China, India, Mexico and Russia are growing sales around eight times faster than in Canada, Germany, UK and USA<sup>4</sup>. This will undoubtedly shift the standard and obvious export destinations, bringing up unfamiliar consumer preferences and requiring developed countries to be ready to compete locally with low price manufactured products.

Secondly, the aging tendency across the globe is raising a demographic deficit that may indicate a profound transformation in the financial wealth of consumers<sup>5</sup>. The shortening of pension plans that result from the fact that people are now forced to work longer may turn mature consumers more sensitive to price changes. The children’s segment of the global footwear market can eventually shrink even more, considering it is already the smallest with only 18% of the market’s total value registered for 2015. Moreover, the increasing importance of the health sector may drive consumers to start to value more therapeutic and comfortable footwear that lead producers to reshape their creations.

The sharpened increase in women’s footwear consumption is also, in part, devoted to the respective educational and working progression which is granting them more economic independence. As a consequence, more fashion and image conscious is being brought to the industry, pushing traditional athletic-wear leader brands to rethink the way they design and manufacture their footwear<sup>6</sup>.

The rise of a new globalization era that results from the easy access to the internet, massification of information and boundless journeys among distinct countries and cultures is leading young generations to think and act like citizens of the world, letting behind personal and cultural standardized laces. Global trend lovers will also emerge naturally while people are massively moving to urban areas, reinforcing the value of brands, style and fashion as significant inputs for social status.

Similarly, online is playing a crucial role as the primary omnichannel vehicle to address customers’ need to create close emotional bonds with the brands. From the producers’ perspective, this has never been so challenging, as they are pushed to (re)act faster to the constant variable preferences of their targets, adapting new-product development cycles from weeks to hours, impacting the corresponding logistics and operations’ management<sup>7</sup>.

Sustainability is also one of the themes that has been calling out more attention from the industry. The fast fashion trends have been contributing for consumers to treat some of the lowest-priced products as nearly disposable, discarding them with little to no usage<sup>8</sup>. These practices will soon have attached damaging environmental effects due to the overconsumption of the resources required for its production and consequently deteriorate workers and workplaces’ conditions. Companies will then be compelled to decide whether to implement more transparent and improved manufacturing practices or to contend with conscious consumers’ complaints that can be largely amplified publicly.

## Part 2. Introducing Freakloset

### 2.1 Behind the camera

Confident that she had what it takes to tackle some of these dynamic industry changes, back in 2014 Joana Lemos decided to launch in a new venture and started to carefully plan what it came to be the Freakloset. Together with Diogo Simões from day one, to whom Joana trusted the accounting and financial functions of the company, the two entrepreneurs with 24 and 25 years old at the time, embraced the challenge of creating a disruptive business model for the Portuguese market, but flexible enough to extend its segment to all Europe from the beginning.

With a bachelor in Management and masters in Marketing, the founder of the brand, recognized the potential of this business area. Furthermore, she looked for all the opportunities that could grant her a more solid knowledge about all the involving subjects, which included a postgraduate degree in Design, a footwear design course and a graphic design degree in New York and countless hours spent studying prototypes and visiting factories to gain a deep insight of the whole process<sup>9</sup>. Diogo also participated in many of these processes, despite his main focus was to coordinate the financing and fundraising initiatives and monitor expenditure and liquidity, crucial steps in the company’s early days when the initial investment of 80kEur had to be carefully controlled to respond to all the financing requests needed for the launch.

One year and a half after, in June 2015, it was the time for Arianne Amores, to join the team. The bachelors in Communication Sciences, Publicity & Marketing and Public Relations and the subsequent Masters in Design and Visual Culture brought to the original team the remaining insights and workforce they were lacking to face the extremely demanding efforts that a new fashion business asks for. Freakloset then closed its team and the three worked full time focused on the foundations of the brand that was planned to start to sale in mid-2016.

### 2.2 About Freakloset

Freakloset emerged as a shoe customization<sup>10</sup> company that aims to create a new philosophy of buying, engaging the consumer in a new shopping experience, providing the market with unique and thoroughly thought design pieces. The major motivation for the founder was to be able to create a brand of timeless high-design basic styles of footwear, for both men and women, totally customizable by color, that could complement anyone’s closet, according to their own preferences.

Favoring, above all, the design and quality features, Freakloset’s first collection was inspired in five of the most classic shoe models (Derby, Monk, Loafer, Ankle boot and Chelsea boot) in an attempt to give them a twist, either in color combinations, heel size and material composition, giving them a more casual or even sporty look, with a guarantee of comfort and durability.

According to a research produced by the EuroShoe Consortium in 2002<sup>11</sup>, fit and comfort are the most important criteria in the buying decision and producers should focus on making the fashionable shoes more comfortable.

Despite fit/comfort is not the object of their customization process, by dreading to turn the process too complex, boring and confusing for the customer at an initial stage, Freakloset tried hard to accomplish this criterion in the production of their footwear standard lasts. The creation of a unisex shoe line may represent an ultimate form of simplicity and homogeneity but it took a doubled effort to adapt the foot

measurements to each anatomical gender specification. It took more than a year just between prototypes and foot trials until they reached the final formula, that can still be adapted, that breaks up with the label that conventionally, classic shoes are not supposed to be comfortable.

One of the aspects that helped to address this matter was the choice of the components. Aware that many people complained about the rigidity and aches caused by the counters [Exhibit 4], Joana decided to innovate and introduced neoprene to the basic shoe composition. What it seemed to be just the solution for a pain point by being the most comfortable and versatile material, ended up being one of the companies' flags pointed out as a true differentiation factor [Exhibit 5].

This has not been an easy task though and it was a great challenge for manufacturers to joint this malleable material, mostly known for its surf suits' application, with the consistency of leather and suede, something that any of them had tried before. But after a few trials and adaptations, the result was worth seeing. Besides the neoprene, components such as latex and sponge are applied in every shoe part that embraces the feet, such as the tongue and the vamp, intending to provide the best comfort experience.

More than just a shoemaker, Freakloset sets as a promoter of a self-expression concept and is currently working to empower customers to set their own rules by trying to gather people that share similar interests, in a sense of community, in order to create a group of brand followers, rather than unidentified categories of generic clients.

### **2.3 Bespoke e-commerce sector**

Since the time when Freakloset's business plan was being designed, many things have changed within the bespoke e-commerce sector, especially in terms of players. Some of the industry's few pioneers just vanished (cancelled their customization service or have been acquired) while others simply grew. There was also a couple of characteristics shared among the operating players that highlighted the potential attractiveness of this sector for new entrants and stimulated new ventures to join and progressively enlarge the size of the market.

From the analysis of 15 of the current market's players and direct competitors [Exhibit 6], one can notice that most of these characteristics actually remain unchanged and there is still space to improve. By analyzing each one of them individually, it is possible to find out that many of them keep applying some gender restriction (by specializing their products for either men or women separately), keep relatively higher prices than comparative standardized online players, still offer a large delivery time, up to 4,5 weeks on average, and some even present user-(un)friendly interfaces or slow processors that seriously undermines the client's user experience.

The identification of some of these industry pitfalls, lead Freakloset to clearly define what they believed to be the key success factors required to thrive. According to the founder's vision, it involved having a significantly agile and optimized process, work together with experienced and skilled industry players, offer a user-friendly and realistic software, keep always the door opened for innovation and constantly encourage a new philosophy of buying.

As a result, Freakloset shoes achieved to be noticed and praised for their minimal design of unisex pieces, unlikely fabrics and materials, coloured soles and comfort<sup>12</sup> within the premium segment.

### **2.4 Freakloset operating model**

To turn this into a reality, all the shoes are carefully handcrafted in São João da Madeira, one by one<sup>13</sup>, avoiding the traditional undifferentiated mass production and through an obviously more time consuming and costly process. However, they are managing to stabilize the delivery time around 3 weeks, lower than the average direct competitors. This is possible mainly due to the choice of the right manufacturer that, according to the CEO, was not simple to find. Freakloset already left behind three other producers but is now fully satisfied with the agility and execution of the current one.

Initially, Freakloset was planned to sell exclusively online. The truth is that it was more difficult to enter the e-commerce sector than they originally expected. The online shopping resistance they faced, especially in Portugal, made them adopt an alternative plan. The fashion industry is still largely dominated by the big brands and they soon realized that entering the offline retail market would allow them to more easily access and build a solid trust base with the clients. Right now, they are physically present in four stores in Porto (Scar-ID), Rotterdam (MNDS Shoes), Seattle (Gibran) and their own showroom in Lisbon where they have their office. The choice of the stores is far to be random or the result of a desperate search for the first opportunity. In fact, the decision was deliberately taken according to a series of strict criteria that accounted for the need to be placed next to brands that share the same target, positioning and design concept. When it comes to Online, apart from their own website, they are also recently selling through three other stores (Minty Square, Fancy and Tuedder) that similarly agree with the same terms.

This does not mean they have lost their original focus. Freakloset website is still and is planned to keep their main channel driver, especially because of their bespoke IT system. The advanced 3D software they have created is definitely one of the major assets of the company. Simple and intuitive, the web server software allows customizing four distinct parts of the shoe in just a matter of seconds, which is something largely appreciated by customers.

So far, exports have reached more than 24 different countries. In the next couple of years, the founder expects sales' distribution to be 80% international and only 20% national, putting a strong emphasis on the need to create a global brand.

As a premium brand, the customized products were initially prices between 270Eur and 300Eur. After the recent improvements in the overall process and a slight margin shrink, the startup managed to decrease the range to 155Eur and 220Eur which turned the shoes much more affordable without losing the medium/upper-class status.

## **Part 3. Freakloset strategies: challenges or opportunities?**

As most of the startups with a disruptive mindset and business model, especially the ones that dare to enter a more traditional industry, Freakloset had to have the courage to go against many dissonant voices and faced many challenges during the last three years of walk-through.

Despite conscious that the market dynamics are not immutable and things often change much more frequently that they manage to forecast, the decisions they have taken make part of Freakloset's DNA. Consequently, the goal of this chapter is to take a deeper look of the main strategies that define Freakloset in order to discuss, in a broad context, how have they been globally approached and if they are being correctly applied to the startup according to its overall characteristics that have been explored in the previous chapters.

### **3.1 Customization**

Mass customization is about to become a reality when already over 36% of consumers show their interest in consumption pattern of personalized products or services, according to a research made by the business advisory firm, Deloitte<sup>14</sup>.

When questioned about the increasing cultural demand for personalization in fashion, Shamil Hargovan shrewdly remembered that customization itself is not a trend, it is actually the original form of producing goods. Footwear and apparel pieces used to be individually conceived for their end-users, by tailors and dressmakers, and it just changed when mass production throve<sup>15</sup>. With mass production evolution over the years, more and more companies entered the market, flooding it with undifferentiated products and services in a desperate attempt to draw the attention of a potential customer. However, this inevitably contributed to increase the consumers’ empowerment. Consumers are now in a position where they can choose what, when and from whom they want to buy. They are actually becoming more rigorous, especially in fashion, with constantly changing preferences, looking for original pieces that are able to reinforce their identity.

Despite aware that the complexity and expense of customizations can often undermine the promising success of a company, Freakloset defined customization as the most suitable way to address the particular needs of their customers. And this is exactly what customization is about: a ‘client-centric’ approach that integrates customers in the value creation process of the organization. But this cannot be exclusively seen as the result of an altruistic attitude towards the customer. This is, in fact, a win-win situation because by allowing them to participate in the creating process of virtual and real products, companies can efficiently use them as marketers and co-creators for their own benefit and simultaneously gain a deep knowledge of who they are and what are their preferences that can be later used to improve their customer experience.

The constant evolution of online configuration softwares and 3-D digital modelling are giving shoppers the power to envision a pretty reliable prototype of what their own creations will look like, engaging and stimulating them to pursue the remaining customer journey until the final purchase.

Moreover, generically, customized footwear players can manage to set slightly higher prices, around 30%, compared to standard products but the greater benefits are not only to charge a higher price but the chance to forgo the existing price competition and shift the focus from price to value proposition<sup>11</sup>.

A great challenge that can emerge for producers is the need for an adequate synchronization of inventory management for all components, to ensure a desirable service level for the respective customized products<sup>16</sup>.

Simultaneously, by delivering customized products made to order, companies will tend to become increasingly inventory-less. Consequently, firms will be able to smooth the high burden driven by excessive inventory carrying, warehousing and administrative costs, simultaneously reducing the amount of write-offs and the inherent promotions they are often forced to undertake to sell obsolete inventory<sup>17</sup>, because customers now pay before they are put into production, ultimately contributing to increase companies’ margins.

Customization can be applied to footwear essentially over the following three areas: style/aesthetics, fit/comfort and function/performance. Each one of them has specific implications in the shoe lifecycle process (design, production and sale), specialty in terms of complexity, duration and costs, which can then be reflected in several concrete components such as the investment in technology, manpower, organization, promotion of the new concept and supply chain<sup>11</sup>.

The Style customization, where Freakloset is currently positioned, can be pointed out as the relatively less complex of the three because although it demands additional efforts from the design and sales perspective, by pressing producers to analyse more possible offer combinations and to revamp the traditional sales’ network, it is also the one that has the lower impact on the manufacturing process which grants the flexibility to keep these costs as low as possible. According to Goonetilleke et al., (2012: 630), this ends up being the most used dimension by both producers and customers and it is mostly driven by the latter through a web-configurator<sup>18</sup>.

### **3.2 E-commerce vs. Brick and Mortar Stores**

One of the main transversal discussion topics that has been brought to the table regarding the current evolution of retail underlies the right balance between e-commerce and storefront operations.

Recently, the world has been witnessing an explosion of digital direct-to-consumer retail brands trying to reach multiple niches that were once ignored or inexistent and capable to offer larger discounts and better products due to their online-only presence<sup>19</sup>, turning comparative shopping even harder.

New generations have also started to shift their habits. They have now easy access to all the detailed information about products, look for peer reviews and explore price benchmarks, pushing brands to offer maximum convenience at the lowest cost possible<sup>20</sup>. Statistics reveal that 67% of Millennials and 56% of Gen Xers prefer to shop online rather than in-store<sup>21</sup> and as of the end of 2015, they together represented around 48% of the US population, which make them the main responsible for the reshaping of retail space.

Footwear and apparel is the leader category most likely to have been purchased in the last 12 months (77%), with 28% of global shoppers purchasing most or all of their clothing and footwear online in the last 12 months, according to the PwC’s 2017 Total Retail Survey<sup>22</sup>.

However, this hasn’t necessarily been an obvious decision, especially for start-ups. Online retail has also become a crowded space and progressively more expensive. New entrants often find the attempt to bid on keywords for the first page of search results impossible due to the huge costs they are not able to afford, when facing competition from larger and well-established retailers<sup>23</sup>.

Moreover, Online rhythm and dynamics also demand companies to be able to grab the attention of their potential clients on the webpage in a matter of seconds. Despite online and apparently distant, e-commerce interaction with customers must be set as close as possible. Customers need to feel the attention, support and knowledge sharing experience exactly as if they were being served by a collaborator in a physical store or companies risk to lose them and never get them back<sup>24</sup>.

One of the factors that e-commerce is constantly trying to improve but is not there yet is the traditional ‘try and take it’ philosophy, where right after properly analysing the products customers can immediately get them home instead of having to wait for the characteristic delivery time.

A theory that a hybrid approach is going to be the right way to serve future customers is also gaining strength especially among some of the most iconic retailers like Walmart. According to its CEO, Doug McMillon, “Customers want to save money and time and have the broadest assortment of items, and we think that by bringing e-commerce and digital capabilities together with the stores, we can do things that a pure e-commerce player can’t”<sup>25</sup>.

What many small-scale companies are starting to do instead of investing in the whole store infrastructure is to take advantage of shared physical concept stores or showrooms.

Showrooms allow customers to examine, ask for advice, touch and try products, which is extremely useful for differentiated products. Staff training can then be mostly focused on brand specifications and products features’ expertise, which can drive conversion of browsers into actual customers and boost sales<sup>22</sup>. Customer experience in-store has also been excelled with customers being constantly helped to select the adequate items for them and assisted regarding how to place orders on the website, in case it’s needed.

### **3.3 Internationalization Process**

From the moment of its foundation, it was clear that as most of the recent new-born businesses, Freakloset needed to be conceived from a global mindset perspective.

Regarding the manufacturing and production place, there was no doubt that Portugal would be the chosen country. Freakloset early decided they wanted to commit in leveraging the “Made in Portugal” label and make the best use of the long and experienced industry that can probably provide the some of the highest quality products associated with relatively low production costs.

However, soon the founders realized that Portugal still offered some resistance regarding the online shopping experience and that the premium price of their shoes was quite above the average retail price for the county. As a result, the internationalization process was always a concern and to set Europe as its launch pad has been the startup primary focus.

Whereas some players, especially outside the EU borders, use to face it as a single joint market, Freakloset decided to segment it and approach each of the markets individually, one at a time. The major pinpoint has been to find where to start and how should they address each of the intended markets in particular.

The attention of this analysis was drilled to the countries’ digital consumption habits [**Exhibit 7**], appetite to consume imported footwear [**Exhibit 8**], preference for portuguese shoes [**Exhibit 9**] & [**Exhibit 10**] and the average import price per continent [**Exhibit 11**].

From a long list of 33 potential countries, a Top 6 was defined, specifying the ones that should compose Freakloset priority targets. According to a research made by Startup Genome, 74% of startups fail because of pre-mature scaling<sup>26</sup> and a planned, restrained and wise recommendation is aligned with the strategy that Freakloset has been conducting so far.

Among the chosen countries, all of them share a very similar online consumer style and have identical shoe buying tastes. Furthermore, when analyzing each market’s trends, competitive landscape and prospect, excluding certain singularities that require each one of them to be approached individually, was possible to identify the following attractive common traits:

- internet footwear retailing was the most dynamic distribution channel in 2016;
- large contribution and openness to international players;
- content delivery through social media, hassle-free returns and cooperation with established store-based retailers were the most used strategies to attract reluctant adopters;
- increasing demand for high quality and premium products and materials with longer durability;
- luxury consumers and men’s segment, in general, are starting to look at footwear as a reflection tool of their personality and lifestyle and above all, a fashion statement;
- retro trend is leading brands to get inspiration in old design pieces;

Consequently, these insights came to confirm what statistics had already shown and the conditions for a positive Freakloset adoption are gathered and safe in each one of them.

However, there are some provisos that also need to be considered when a startup thinks about to expand, including whether their marketing strategies, operations, product focus and financing are ready and aligned with this shift<sup>27</sup>.

When marketing is applied to an online retail business, is inevitable to mention the increasing importance of content marketing. In fact, some authors point it as the new social currency<sup>28</sup>. Considering the appropriate context, more than ever people and businesses are defined by what they share on social networks and this is exactly what allows to build the identity of a person or a brand. If people are able to feel engaged and recognize the brands as source of forward-looking ideas, they will follow them and much easily convert into clients. This factor has been clearly highlighted by the startup which has been dedicating most of their budget to marketing and promotion.

Secondly, the internationalization step should only proceed a solid and succeeded proof of concept in the original market where they manage to validate the products’ acceptance and the ability to adapt the installed capacity of the operations like the suppliers, the manufacturer, the systems and the human resources to a sharply increase in the demand and eventual new challenges that will start to rise such as more frequent new product lines, sizes’ adaptations, request for more perceived value, price competition, etc.

Another very important component that will allow supporting all the related features is to be able to hold and process or outsource a data analysis tool. As companies start to scale up and expand, the more distant they are placed from part of their end-customers the harder it is to keep a strict control over their interactions and of every milestone of the operations flow. Data analysis plays a crucial role in tracking the entire journey of a customer, from entry to exit, being responsible for monitoring customer preferences and website behaviour, collect and process feedback<sup>29</sup> to ultimately deliver personalized offers/content and improve the shopping experience. More than this, the information collected can be used to support the key business strategies by providing a cross-overview of the fragilities and strengths of the company’s business model and how do they reflect on its financials, as long as they guarantee the capacity to decipher it<sup>30</sup>.

Finally, the financial issues are an unavoidable topic when considering about to grow a business. Marketing costs, HR hiring, IT improvement and product developments will require a large capital inflow and very few firms, especially startups, are able to succeed without new outside investment. With this in mind, Freakloset has managed to keep a prudent strategy regarding its expansion progress and despite they have not established any export restriction, they comply with a strict scope of where and when to channel their investment to approach a certain market instead of trying to expose globally at once.

### **3.4 Funding Needs and Equity Split**

Until now, Freakloset has been funded due to the support of family and friends and recently from the program Portugal 2020<sup>31</sup>.

After the idea stage that resulted from Joana’s thesis work project, Diogo Simões joined her and the two started to operate the business with an initial investment of 80kEur.

The whole process required to put the first pair of shoes on the market took around two years and the major costs were driven essentially by Marketing & Advertising, channeled to photoshoot operations, promotional videos, model casting and social media; the Website platform, a 3-D sophisticated but intuitive software designed from scratch and finally, product development and manufacturing that involved multiple phases of prototyping, component analysis, quality tests, proofs of concept, etc.

As soon as they had something to show, Freakloset started to attend some of the most relevant national and international fairs, essential in the footwear industry to raise brand awareness among the main industry players and investors. On the other hand, this represents an extraordinary cost, especially for startups, as stand rents can often roughly range between 5k-20kEur.

Here needs to be highlighted the extremely important role of APPICAPS, the Portuguese Footwear, Components, Leather Goods Manufacturers’ Association, and the cooperation with the program Portugal 2020. Right now, more than 40 companies, including Freakloset, are taking advantage of the existing support in strengthening and promoting the brands, within a program that aims to sponsor the means required for companies to participate in fairs and in new investments in technology. Until the end of 2017, they are expecting to invest up to 1,3MEur to help the candidates to value their offers and improve their projection all over the world.

The investment received from the program and an additional capital increase from a family and friends’ round led Freakloset to afford so far a total of 250kEur from external funding. However, it is important to notice that the founder is still the global ultimate owner of the company with 100% of its common stock, which means that no equity has been distributed yet.

This is not a typical condition since, at this stage, founders are already forced to slice the pie not only for the F&F participation but also because major concerns about the need to raise an option pool, which means to set aside stock for future employees, start to emerge. This is actually a matter that should be planned in good time because it may become key when startups intend to attract and retain talent in future.

Considering the traditional funding flows applied to startups, the next natural step for Freakloset should be to evolve into an Angel investor. While Friends and Family typically may not have deep pockets, invest very early on and mostly on the entrepreneur rather than in the business, Angels are individuals with a net worth of at least \$1M or with an annual income of \$200k that commonly fund the last stage of technical developments (prototype or Beta versions of the product) and the initial journey when the startup enters the market<sup>32</sup>. The first usually invest from \$15k to \$200k while the latter usually enters for an amount up to \$2M, at a \$1M valuation.

Despite the recent investments, Freakloset will definitely need to rely on a further round in order to leverage its expansion. The immediate consequence is that the founder will start progressively to lose control of the company but the right mindset should be to keep aware that 100% of nothing is far way less than 5% of a huge pie<sup>33</sup>.

Another option it has in hands is to try to jump off directly to a Venture Capital fund that is able to invest in them. Venture capitalists tend to persuade external investors to put money in their fund, starting offers at \$500k when they believe startups are worth on average \$4Million. This type of investment usually aims to boost company's growth and rapidly increase its market share.

Both Angels and VCs usually have previous experience in the same field they invest so either of them has the potential to bring valuable knowledge, expertise and network to the business. Moreover, they are highly motivated for not only to get a high return but also to get involved in the decision-making process by ensuring they get a board seat so they can closely control the performance of the startup.

However, apart from the size and stage of investment and level of involvement, there are a few more criteria that might weight in the startup decision to which type of investor better suit their current needs. One should also always remember that raising capital is a resource consuming process and, when concluded, companies keep chained to investors usually for a long time. For this reason, it is then extremely important to choose the right partner that more than money is capable to add value, challenge and support the business when things seem quite troubled.

## **The take-off**

Those and other questions were not stopping to break into Joana's mind until someone suddenly touched her shoulder. When she looked up, the air hostess smiled gently, signalled her to straighten her seat and moved forward. The flight was finally about to take off. And so did Freakloset.

## Part 4. Questions

**4.1** How do you evaluate Freakloset's prospective business? Do you consider it an attractive investment opportunity?

**4.2** What are the major benefits and challenges of customization when applied to the footwear industry? Do you think an exclusive customization business is sustainable to scale up or should customization be seen as a complementary service? In your opinion, can mass customization become the future of footwear?

**4.3** Considering the overview of the actual dilemma between e-commerce and brick-and-mortar stores, what is in your opinion the best strategy that Freakloset should follow? Please list how each scenario impacts the companies' asset intensity and point out, in this case, which one would allow Freakloset to benefit considering its expansion ambition.

**4.4** Regarding Freakloset's international expansion, how would you evaluate the startup's strategy to approach each country separately (i.e. one at a time) instead of entering a larger range of markets simultaneously? What are the pros and cons of both the strategies? Based on the data provided in the Exhibits (7-11), please target the Top 6 countries that should compose Freakloset's priorities.

**4.5** Imagine that Freakloset manages to find an investor up to invest today \$2,5M in the company. What equity stake would he demand today considering that he expects an exit in 5 years, with a return of 30%, at the future value of \$24M? Please note that more investors are expected to join future rounds and will acquire a total of 20% stake in Freakloset before the exit. What if the other investors have already acquired the 20% stake before this investor stepped in? How would this impact the stake he was about to ask for?

*Disclaimer: These data are fictitious and are supposed to be exclusively used for the purpose of this exercise.*

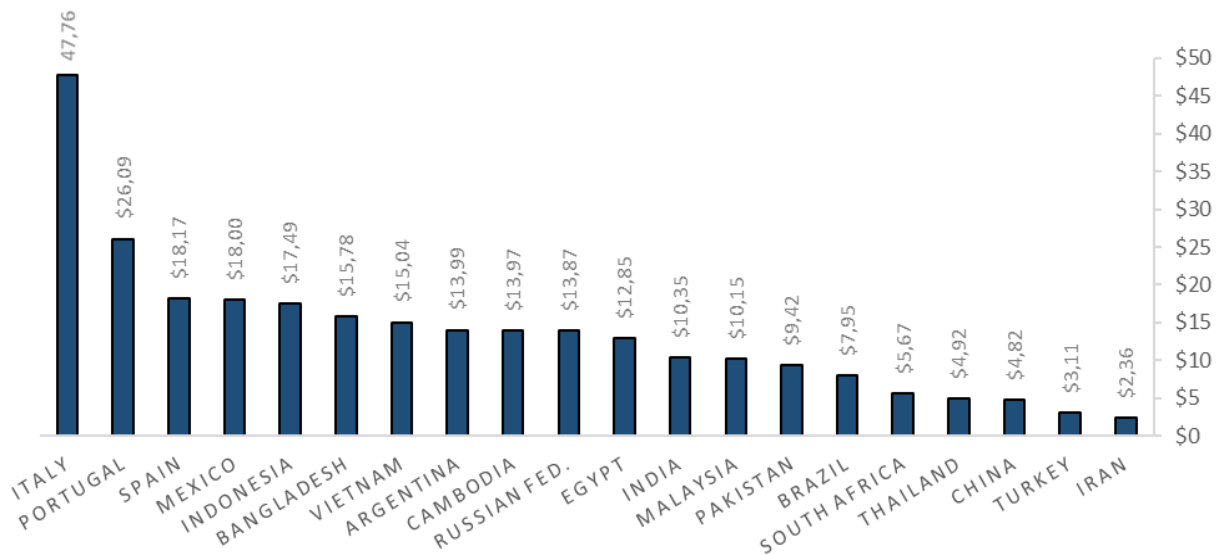
**4.6** As it was mentioned in the last chapter, there are not yet spared shares for an option pool purpose. Comment on this decision and indicate how are they so relevant to attract and retain talent.

**Exhibit 1** Top 10 Footwear Producers (Quantity) 2016

#	Country	Pairs (Millions)	World Share
1	China	13 100	57,4%
2	India	2 257	9,6%
3	Vietnam	1 185	5,2%
4	Indonesia	1 110	4,9%
5	Brazil	954	4,2%
6	Turkey	500	2,2%
7	Pakistan	399	1,6%
8	Bangladesh	378	1,6%
9	Mexico	254	1,1%
10	Thailand	200	0,9%

Source: World Footwear Yearbook 2017

**Exhibit 2** Average Export Price among Top 20 Producers 2016



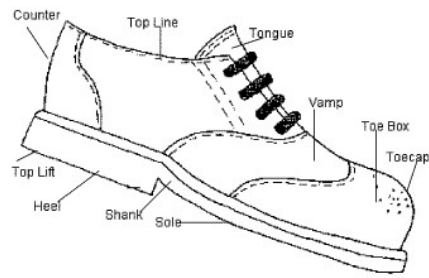
Source: World Footwear Yearbook 2017

**Exhibit 3** Average Export Price Evolution 2000-2016



Source: World Footwear Yearbook 2011 & 2017

**Exhibit 4** Shoe composition



Source: <http://leatherworker.net/forum/topic/43999-shoe-part-reference/>

**Exhibit 5** Freakloset models: Counter’s neoprene composition



**Exhibit 6** List of 15 Freakloset’s Direct Competitors

#	Company	Website link	Foundation	Country	Gender	Price	Delivery	Target Market	Point of Sale	Shipping Costs
1	AliveShoes	www.aliveshoes.com	2011	Italy	M/F	169€ - 249€	3 - 4 weeks	Worldwide	Online	Free express shipping to EU, UK and USA
2	AWL & Saundry	www.awlandsundry.com	2012	USA	M	Avg. Price 300€	4 - 5 Weeks	Worldwide	Online	Free shipping
3	Briteshoes	www.briteshoes.com	2014	Spain	F	190€ - 250€	4 - 5 Weeks	Worldwide	Online + Stores	Shipping fee (free to Spain and Portugal)
4	Custom & Chicc	www.customandchic.com	2013	Spain	F	139€ - 286€	4 - 6 Weeks	Worldwide	Online	Shipping fee (free to Spain and Portugal)
5	Daniel & Lade	www.danielandlade.com	2012	UK	M	160€ - 360€	4 - 6 Weeks	Worldwide	Online + Stores	Shipping fee
6	Designby.me	www.designby.me	2013	Germany	F	Avg. Price 190€	4 - 5 Weeks	Worldwide	Online	Shipping fee
7	DIS	www.designitalianshoes.com	2014	Italy	M/F	Avg. Price 300€	4 Weeks	Worldwide	Online + Stores	Free express shipping to EU, UK and USA
8	GlentShoes	www.glentshoes.com	2011	Spain	M	Avg. Price 300€	4 - 6 Weeks	Worldwide	Online + Stores	Shipping fee (free to Spain and Portugal)
9	ItailorShoes	www.itailorshoes.com	2010	Thailand	M	49€ - 119€	5 - 6 Weeks	Worldwide	Online + Stores	Shipping fee
10	Just Ene	www.just-ene.com	2014	Spain	F	245 € - 530 €	4 - 6 Weeks	Worldwide	Online + Stores	Shipping fee
11	Pembertons	www.pembertons.briteshoes.com	2016	Spain	M	190€ - 345€	4 - 5 Weeks	Worldwide	Online	Shipping fee (free to Spain and Portugal)
12	Rancourt & Co	www.rancourtandcompany.com	1967	USA	M	400 €	3 - 4 Weeks	Worldwide	Online + Stores	Shipping fee
13	Shoes of Prey	www.shoesofprey.com	2009	Australia	F	129 € - 350 €	4 Weeks	Worldwide	Online	Shipping fee
14	The shoe design studio	www.shoedesignstudio.com	2009	Singapore	M/F	170€ - 300€	4 - 6 Weeks	Worldwide	Online	Shipping fee
15	Undandy	www.undandy.com	2015	Portugal	M	Avg. Price 220€	2 Weeks	Worldwide	Online	Shipping fee (free to Portugal)

Adapted from: *Bespoke E-commerce – Customização em massa no calçado: estudo de caso múltiplos* by Hugo Rodrigues

**Exhibit 7** Digital Consumer Index 2016

Rank	Country	Current score
1	United Kingdom	60.0
2	South Korea	59.2
3	USA	58.0
4	Denmark	57.7
5	Norway	56.9
6	Switzerland	54.7
7	Australia	53.7
8	Sweden	53.7
9	Netherlands	53.1
10	Singapore	52.6
11	Japan	50.6
12	Hong Kong	48.5
13	China	47.8
14	Belgium	47.2
15	France	47.2
16	Canada	47.2
17	U. Arab. Emirates	47.0
18	Germany	45.7
19	Israel	45.1
20	Taiwan	44.7

Source: Euromonitor | Competitive Strategies in Apparel and Footwear 2017

**Exhibit 8** World Top 20 Consumers in 2016

Rank	Country	Import Share of Consumption	% World Consumption (Pairs)	% World Imports (\$)
1	Germany	149,4%	2,1%	8,6%
2	United Kingdom	139,3%	2,5%	5,6%
3	Spain	125,0%	1,1%	2,7%
4	France	120,8%	1,9%	6,1%
5	Italy	105,7%	1,5%	4,4%
6	USA	102,3%	10,8%	22,2%
7	U. Arab. Emirates	100,8%	1,4%	1,4%
8	Japan	92,2%	2,9%	4,4%
9	Philippines	78,9%	1,2%	0,2%
10	Russian Fed.	65,9%	2,0%	2,3%
11	Vietnam	26,9%	1,1%	0,4%
12	Mexico	26,5%	1,5%	0,8%
13	Iran	23,3%	1,1%	0,2%
14	Turkey	11,0%	1,5%	0,6%
15	India	10,2%	10,6%	0,4%
16	Bangladesh	6,4%	1,8%	0,1%
17	Pakistan	5,2%	1,8%	0,1%
18	Indonesia	2,7%	4,1%	0,2%
19	Brazil	2,7%	4,0%	0,3%
20	China	2,2%	18,3%	2,3%

Source: World Footwear Yearbook 2017

**Exhibit 9** Portuguese Top Export Markets 2016

Rank	Export Markets	Million USD	Value Share	Million Pairs	Quantity Share
1	France	461	22%	17	20%
2	Germany	378	18%	13	17%
3	Netherlands	300	14%	10	13%
4	Spain	211	10%	13	16%
5	United Kingdom	148	7%	6	7%

Source: World Footwear Yearbook 2017

**Exhibit 10** Portuguese Export Markets Last 5 Year Variation

Export Markets	Value Share	Million USD
USA	337%	65
Denmark	32%	25
United Kingdom	-14%	-23
Spain	-14%	-34
France	-18%	-100

Source: World Footwear Yearbook 2017

**Exhibit 11** Average Import Prices by Continent 2016

<b>Continent</b>	<b>Import Price</b>
Europe	\$12,77
Oceania	\$10,80
North America	\$10,68
South America	\$8,94
Asia	\$7,39
Africa	\$3,26

**Source:** World Footwear Yearbook 2017

## Notes

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## **Teaching Notes**

The following case study was thought with the goal not only to promote but also to make the students dive into one of the most valued portuguese industries worldwide, the footwear industry.

The strategic plan Footure 2020, defined by the Portuguese Footwear, Components, Leather Goods Manufacturers' Association (APICCAPS), aims to boost the Portuguese cluster to become an international reference within the global footwear industry based on a strong bet in sophistication and creativity. Moreover, the document points out the Qualification and Rejuvenation, the Innovation and the need for Internationalization and Communication as the primary pillars to build a national productive, sustainable and highly competitive industry prepared to thrive in the worldwide panorama.

Consequently, the Portuguese footwear has been inviting more and more entrepreneurs and a new generation of companies to join and contribute to explore this cluster in and outside the country's borders.

The main purpose of this case-study is to take a deep look at one of the promising start-ups that are aligned with this strategy and committed in contributing for the industry's success, analyze the major challenges they have faced so far and bold relevant topics that can be covered in the main areas of Strategy, Entrepreneurial Finance and Venture Capital.

Then, Freakloset appeared to be an obvious choice considering these case-study's specifications. A brand born from the disruptive mindset of its founder, Freakloset is pursuing its place in the sun in the online footwear customization sector, with an original interpretation and redesign of some of the most wanted and iconic shoe models.

Above all, when analysing this case, students should be able to understand the major barriers that a footwear startup may come to face, critically analyse how can they manage to differentiate and reflect on some relevant implications of an internationalization expansion.

**Keywords:** Footwear Cluster, APICCAPS, Internationalization, Freakloset, Strategy, Venture Capital

#### **4.1 How do you evaluate Freakloset's prospective business? Do you consider it an attractive investment opportunity?**

The traditional approach to evaluating the quality of an investment consists in developing a valuation assessment of the company, in which the analysts attempt to capture the Equity Value and the Enterprise Value of the company.

However, students are expected to recognize that the best way to assess the valuation of a new venture is by focusing the attention on a framework that can actually measure the startup's specific features, its capacity to generate value, its growth potential and its ability to interact with the global environment of the market instead of focusing on a hypothetical projection or speculation of Cash Flows that many of them often are not ready to generate yet.

Consequently, the assessment of Freakloset as an investment opportunity requires the analysis of many different drivers, not just intrinsic to the company but also related to the market as a whole:

##### **1) Opportunity:**

###### **a. Market**

The global footwear market is currently worth around \$347 billion<sup>1</sup>, has presented stable and consistent growth over the years and is still predicted to grow at a CAGR of 1.95% during the period 2017-2021<sup>2</sup>.

Portugal has also been watching its “portuguese shoes” label recognized all over the world with the growth in value of exports reaching 27,9% since 2009<sup>3</sup>, with an established record of 1.9B EUR in 2016.

Online footwear sales will also continue to grow as they have been over the past years. Online retail has gained special attention lately due to the growing influence of opinion makers (such as bloggers or celebrities) and the increasing perception of the online channel as a better opportunity to challenge the trade-off between quality and price. Footwear and apparel account together for 17% share of global online sales<sup>1</sup> representing some of the most important industries in the digital retailing.

This cluster is typically dominated by few big well-established players that hold the largest share of the market and benefit from economies of scale, lean supply chains and sophisticated big data analytics. In an attempt to beat them, smaller players were forced to adopt alternative strategies and started to emerge into fierce price competition by neglecting the product itself and emphasizing the overall product portfolio, which became the original form of the so-called fast fashion. Most of the players try to offer a large range of products to raise brand awareness in order to attain a larger share of the market.

However, luxury and customization trends in fashion are counterbalancing the fast consumption driven by masses and the market has progressively more and more consumers looking to escape from standardized and undifferentiated products.

###### **b. Product**

Freakloset shoes are intended to be unique design pieces created to revamp the most iconic models with a contemporary twist over the fashion architecture, materials and colours.

The brand's major competitive advantage is the ability to grant customers the opportunity to freely customize their shoes over five different dimensions: the type and colour of the leather, type and colour of the counter and colour of the sole and laces.

The simplicity of the variables chosen turns the process very intuitive, smooth and agile, allowing the customers to get, in a matter of minutes, thousands of distinct and original shoe combinations.

More than just shoes, Freakloset’s products aim to align the quality and comfort to the most cutting-edge trends, by putting most of their effort in the construction of a brand positioned towards those young or young feeling people with an active and cosmopolitan lifestyle that look at fashion as an extent of themselves and a reflection of their personality statement.

Consequently, customers are even more aware that Freakloset’s offer can’t be reduced to the shoes they acquire but involve the overall process from the content and communication they are often already engaged with, the online co-creation process, the irreverent packaging, the home delivery and the attached status that turn a single shopping act in a seamless experience.

Despite we can observe an increasing number of competitors in the bespoke e-commerce sector, including in Portugal with the simultaneous entrance of Undandy, Freakloset is positioned in a medium/high segment which still holds a lot of space to explore with the rise of beauty, self-care and fashion trends for both genders that make consumers to constantly look and pay a premium for original and high-end stylish products.

### **c. Business Model**

Freakloset is an online customization shoe company that purposes to deliver customers, in less than three weeks, the result of their own creation at home.

The startup’s decision to go along with the recent technology and internet trends, by investing in an online based platform and business model opens them a window to much easily track consumer’s preferences and personalize their offers and suggestions. This core feature and consequent data analysis reveals extremely important and useful to make them better understand their customers, improve customer’s loyalty, reinforce their presence in the market and create an eventual future opportunity to share or sell this information to other shoe or fashion’s related producers as a strong market indicator.

The co-creation process occurs through a web-configurator program included in the startup’s website, designed exclusively for the brands’ purpose. The advanced 3-D software, allows customers to select the materials, change the colours and rotate the shoe in a very realistic, user-friendly and quick mechanism that attempts to differentiate from most of the exhaustive, complex and time-consuming tools existent in the market.

Aligned with the shoe personalization, the unlikely fabrics and materials used in the shoe composition requires the company to adopt the traditional made-to-order approach. Hereby, each ordered shoe is carefully hand-made by a judiciously chosen manufacturer. Despite the conception demanding requirements may present an obstacle for future potential production scale, this also constitutes a barrier for eventual easy replicas.

Although they cannot benefit from most of the advantages brought by the mass production tendency that invaded the market, they also enjoy positive aspects derived from this production method that include the up-front payment of each order, which means that the shoes are not produced without the respective payment is ensured. Consequently, through this, the startup can have full and tightly control of the inventory which means they have significantly reduced markdowns and inventory risk that have traditionally plagued the industry, with a significant impact on the companies’ costs. Moreover, the made-to-order approach also implies that the company receives the upfront payment from the customer and manages to pay later to the suppliers, allowing them to keep a low or even negative level of net working capital which grants them an improved cash position<sup>4</sup>.

The key feature that allows this model to be successfully applied is to be able to keep the lead time as low as possible. This is can only be supported by a highly responsive industry which is enhanced by the small-scale portuguese factories that turn it an agile, cheap, and fast process by allowing raw materials such as leather, laces, hides, heels, outsoles, trims and metal components to be imported within a couple of days.

Freakloset charges a significantly higher price compared to most of the country’s average consumption standards, between 115 to 220 Eur, but still on an affordable range when compared to the majority of players competing in the high-end and luxury segments.

In order to stimulate the purchases and avoid some of the price reaction barriers, free express shipping and free returns within 30 days are guaranteed in any order as well as many frequent promotions and special offerings communicated essentially through social media.

## **2) Team**

Back in 20014, Joana Lemos decided to grasp the opportunity of her Masters in Marketing thesis at ESADE Business School to develop a real business plan and slowly start to conceive what in a near future would end up raising as Freakloset. As soon as things started to get shaped, Joana asked her friend Diogo Simões to join her, and become responsible for the Financial and Operations’ departments of the startup due to his work experience as financial controller and manager associated to a previous Masters in Luxury Management.

In a time when the online bespoke sector was still yet to be explored, the young entrepreneurs looked for all the opportunities that could grant them more solid knowledge about all the involving subjects, which included postgraduate degrees and countless hours spent studying prototypes, visiting factories and idealizing the customization 3-D software.

One year and a half after, in June 2015, it was the time for Arianne Amores, to join the team. The bachelors in Communication Sciences, Publicity & Marketing and Public Relations and the subsequent Masters in Design and Visual Culture brought to the original team the remaining insights and workforce they were lacking to face the extremely demanding efforts that a new fashion business asks for. Freakloset then closed its team and the three worked full time focused on the foundations of the brand that was planned to start to sale in the second semester of 2016.

The team members’ areas of expertise, previous experiences and shared passion for the fashion industry allow each of one of them to bring valuable contributions to the business and revealed crucial to draw from scratch a sustained business model ready to address some of the most relevant and challenging trends that are shifting the footwear and apparel global panorama.

An interesting aspect that should be noticed under this topic is that the actual ownership of Freakloset kind of opposes the conventional wisdom of the startups' foundations. Typically, new ventures are also founded by 2/3 members but Equity is usually allocated to each one of them with an equal but fair value, to provide them with similar incentives and rewards for the respective contribution. Despite none of this may apply to this specific case, some of the reasons behind none or unequal equity splits are related to the fact the founders keep claiming to be the ‘holder’ of the original idea; that they have started to work full-time previously to the other co-founders; that they are more experienced; that they were the ones responsible to raise the money, etc.

Nevertheless, it is relevant to remind that most of the great value of a company is generally only reached after 7 to 10 years and the major contribution contrasts of the first year may seem quite unlikely to justify the unequal split for the remaining time. Secondly, if the other founding team members do not perceive to be properly valued inside the company, they might lose motivation or traction and ultimately compromise the promising success of the venture. Finally, the quality of a team is one of the most decisive criteria on which investors bases to decide whether to invest or not. By not splitting the Equity properly, it may pass the wrong message to investors that may induce that the founder has no reasons to trust their team probably because they are performing below what would be expected from them.<sup>5</sup>

### 3) Context

Despite the notable evolution that the traditional shoe industry has been suffering towards a high-tech industry capable of design, produce and deliver in record timing some of the best and most expensive shoes<sup>6</sup> this sector still faces many obstacles regarding the reluctance of some consumers to adhere to e-commerce retailers. However, the numbers are increasingly changing and as more industries’ retailers adopt this approach, the easier these objections fall down.

The sooner customers realize that they can easily find out a larger range of products, more detailed information, better deals and trustable players connected through a much more convenient and responsive way for the customer, the faster they will start to order online.

### Conclusion

Summarily, from an investor’s perspective, Freakloset appears to be an attractive investment with potential future returns associated with a risk-taking opportunity of entering an innovative and luxury market with a strong business model.

The company operations run through a solid business model, which is mostly based on a “light assets” approach. This point is particularly important, since the company is not dependent on a fixed asset structure, and therefore can much more easily adapt to the market trends and consumer preferences. In a certain way, this can be perceived as a free option to abandon case, where the company can leave a certain market, without incurring in high costs. This gives the firm a sustainable competitive advantage.

Moreover, the startup is currently being run by a young and trend-driven team, with relevant knowledge and capabilities focused on the fashion industry. This fact gives extra confidence in the firm’s capacity to adapt and implement innovative solutions to the challenges ahead.

The company has also made a significant investment in R&D and Marketing, which is expected to be soon reflected in the strengthening of the brand and international recognition.

Finally, the fact that their main sales’ channel is their own website, allows them to generate, manage and interpret a significant amount of data from its customers, allowing the firm to better dynamically adjust their offers and meet the needs from the market.

**4.2 What are the major benefits and challenges of customization when applied to the footwear industry? Do you think an exclusive customization business is sustainable to scale up or should customization be seen as a complementary service? In your opinion, can mass customization become the future of footwear?**

Despite the increasingly preference showed by customers for this type of service, companies that are adopting customization must be aware of the major implications that this model can bring to a business, especially the way it impacts the traditional business' operations.

First, to create a shoe customisable collection, designers must beget it already the more ‘customer oriented’ possible, according to the company's defined criteria (gender, target, style, etc.) in order to anticipate an ad hoc adoption of the market and ensure an as-is saleable collection like any other manufacturer. Already at this stage, companies must be up to define which kind of customization will they submit their offering to, which includes a decision over three main vectors: style/aesthetics, fit/comfort and function/performance. This is extremely important to manage customers' expectations and let clear the boundaries of the freedom exercise and process involvement that companies are about to sell them.

In the next stage, the customization process itself actually starts with the corresponding adoption of the original models to each individual customer specifications. Then, companies must be ready to manufacture the shoe according to its order requirements and deliver the final outcome as soon as possible.

By looking at the overall process, the clash with the traditional model does not seem too meaningful. The major differences rely on the relative importance of each stage, the moment they come into play, and the way they need to be managed. The capacity to address them highly depends on the availability and quality of the resources that the company affords, which must include pervasive IT systems, flexible production and supply chain operations and high sense of product focus.

Customization influences order management, moving from the traditional ‘make to stock’ to ‘make to order’. This implies that, generically, each shoe is produced and delivered individually, contributing to an increase in the complexity of planning, scheduling and tracking orders as well as a sharp rise in each unit costs. As soon as the business starts to grow, distribution costs will drive steeply upwards due to more frequent spread delivery of an increasing number of lots with a significantly lower (or even just one) number of shoe pairs.

Summarily, companies that aim to scale up will have to be conscious of the needed significant investments to automate the production and assembling process by buying innovative and adaptive systems, the training and change management costs required to put in practise the new automated machines and also the capital required to install a software responsible to help them to carefully manage the production and the customer relationship.

On the other hand, this type of service also has attached benefits at many levels.

First, MTO also grants the company a reduction in stocking costs since stores and warehouses are no longer packed with shoes waiting to be sold. This often represents a meaningful cost because it makes companies pay for the space that could be occupied with other more profitable products or simply because most of them end up obsolete which forces companies to dive into huge promotions with tiny or no margins or to consider them a write-off.

Secondly, every time they release a customisable collection, the offering range they actually put in the market is much wider due to the countless combinations that their personalized options allow them to build. Although this is quite subjective, in a certain way it reduces the pressure to keep constantly introducing new products in the market since often customers tend to treat each possible combination as a unique product, which can be translated into multiple product sales.

Another advantage is that bespoke products are almost always more expensive than mass-produced ones, and perceived as premium. Consequently, most of the inherent production costs can be immediately inputted in the price as customers are even more aware that the improved quality, control, comfort and personalization are part of the experience and all of these have an associated cost that must be covered.

Finally, marketing costs, that are certainly very high, are balanced by the opportunity that these new tools provide to collect valuable data directly from the final consumer which permits a reduction in the “communication chain”. Hence, the recognizable effort they make to address each customer individually and embrace their pains and preferences as their own, is leading these companies to find new customers in niches and segments they were not even expecting to enter, sometimes too far away, which turns much easier the expansion progress and plausible to dream about a global affirmation.

According to most of the global retail trends’ analysts, bespoke will continue to grow and footwear industry will keep leading this tendency side by side with apparel. Customers are tired of being disappointed with the lack of fit solutions and claim the need to have a word to say in the conception of what intend to acquire. Consequently, companies should start to worry about how can they prepare their businesses to properly address this.

The capital requirement for an exclusive customization company may be too heavy and many have already failed before they had the opportunity to explore its full potential. However, companies must think about to adapt some strategies in order to anticipate some of the barriers that may undermine their success, which may include incurring in a small-scaled storage exclusively for the most wanted models and agree to rent customized production capacity (based on hours spent or shoes produced monthly) with the end manufacturer instead of committing their limited financial resources in acquiring or renting a whole production unit and the corresponding systems. Based on this model, the business would have time to scale sustainably until the company have the capacity to optimize the production costs.<sup>7</sup>

If bespoke producers manage to improve the production process and approach them of the current mass production standards, the recent trends that show companies valuing the personalization, differentiation and niches confirm that mass customization is likely to dictate a great tendency with a huge impact the future of footwear.

**4.3 Considering the overview of the actual dilemma between e-commerce and brick-and-mortar stores, what is in your opinion the best strategy that Freakloset should follow? Please list how each scenario impacts the companies’ asset intensity and point out, in this case, which one would allow Freakloset to benefit considering its expansion ambition.**

In the case, students are confronted with most of the characteristics from either the online and the brick-and-mortar stores which allow them to have a broad view of the main advantages and disadvantages that each one of them can bring to a company from a business perspective.

Thus, it is undeniable that consumers are starting to perceive Online as the most convenient way of shopping because it turns the experience much less time consuming, allow customers to find the best price and exclusive deals for products, ensure home delivery and diminishes impulsive purchases. From a retailers' perspective, they also benefit from not having to manage and expose expensive storefronts and exploring other cost-efficient solutions such as using directly the warehouses to store and distribute the inventory.<sup>8</sup>

On the other hand, this does not mean the end of brick and mortar stores. So far, they still represent a leading reference on building customer relationships due to the personal interaction with store employees, the ability to touch and experiencing products before purchase, the ability to share a joint socializing experience with other customers and the immediate sense of fulfillment for taking the items home right after the acquisition.

Although the importance of all the issues listed above, it is important for students to recognize how can this decision also affects the startup's financial wealth and debate which alternative can better address its needs.

First, it is important to remind that the companies capacity to generate Free Cash Flow and consequent Valuation will be affected positively by the Earnings Before Interest After Tax and negatively by the change in Net Operating Assets ( $FCF = EBIAT - \Delta NOA$ ), which means that the value of the company will increase if Profitability ( $p = EBIAT / Sales$ ) increases and decrease if Asset intensity ( $a = NOA / Sales$ ) increases.

Asset Intensity here is key because the more robust are the company's assets, the more cash it will request to grow and funding a new venture can become an extremely harsh process. Consequently, particularly in its early days, startups must avoid excessively large asset intensity so that they turn their business more viable and with a higher probability of success.

Thus, invest in plant, property and equipment (NPPE) to acquire stores should definitely stay away from the top priorities of the new ventures. Moreover, even when thinking about to lease or rent them, they must be aware that monthly rents are often accrued with the cost of utilities, maintenance and insurance. Commit with so heavy cash requirements in a stage when most of the ventures are still struggling not to run out of it should also be set aside. Both of these alternatives would also make the company to produce a large quantity of inventory to fulfil the stores' shelves, forcing them to pay in advance to suppliers and assume the risk of uncertainty about when they are able to cash in back from customers, which would represent an additional weight on the asset intensity (NOWC) and a more unstable cash balance capacity.

Finally, the case also presents one of the alternatives that is revamping the retail space which are the shared concept stores and showrooms<sup>9</sup>. This can be seen as a great complementary component of the Online main channel because together can mitigate most or even all the barriers that are stand by the brick-and-mortar stores' traditional concept.

Here, if explored properly, the startups can manage to expose a small range of products that enhance them to set closer to the customers without demanding a huge effort of stocking, and can inclusively avoid rents by establishing mark-up agreements on the items' final price.

According to Freakloset inner characteristics and current strategy, this increasing tendency respond exactly to what they are looking for, allowing them to operate as a lighter asset intensity venture, attempting to generate as much revenue off little capital investment.<sup>10</sup>

**4.4 Regarding Freakloset’s international expansion, how would you evaluate the startup’s strategy to approach each country separately (i.e. one at a time) instead of entering a larger range of markets simultaneously? What are the pros and cons of both the strategies? Based on the data provided in the Exhibits (7-11), please target the Top 6 countries that should compose Freakloset’s priorities.**

The aim of this question is that students manage to relate it with the value of experimentation that is deeply connected with the way the venture capital investment model and the respective behaviour of entrepreneurs have evolved over the last decade.

In fact, Entrepreneurship itself is all about experimentation because there is not a secure and accurate recipe that can be followed to be successful and consequently it becomes very difficult to predict which ideas will have the chance to thrive.

As a result, the high uncertainty that the new ventures face is forcing entrepreneurs to break down conventional strategies in a series of experiments in order to delay high capital commitments and create real options. Instead of putting all their chips on the table, startups just started to realize they can move slower, through cheap and informative experiments, in order to carefully monitor the true probability of success of the strategy and abandon it, without a huge loss, if the scenario does not seem as promising as they originally forecasted.

Each experiment corresponds to a milestone that must be successfully met before entrepreneurs run a further one. The less the cost of the experiment, the more incentives the new venture has to take it and risk, always considering how much it can learn from it. Consequently, as Freakloset’s business model is highly leveraged on the technological progress, the cost of experimentation is significantly lower than many other asset-intensive businesses and this kind of approach is highly recommended.

Freakloset is then taking advantage of this approach to entering each market of its international roadmap sequentially, integrating them in a series of experiments they want to carefully analyse. This will give them the opportunity to deeply know each of the country’s markets and its dynamics, understand how open they are to new entrants, reveal the major difficulties they may come to face, what can they improve, etc. This is expected to be done under cautious steps and controlled budget, so that an unsuccessful performance in a market may not be sufficient to undermine and compromise the overall outcome of the expansion.

This strategy also has its own risk because the time spent on experimenting may lead funding environment to deteriorate and there may be investors that are no longer opened to fund and support the company when it finally feels comfortable to approach them.

On the other hand, the company also had the opportunity to expand, at least for the other EU countries, at just one pace. It is legitimate to consider that it would facilitate the creation of a global network, help to raise awareness and allow them to take advantage of potential synergies. However, the hurdles related to the language, compliance, local competition and finding the right partners<sup>11</sup> would certainly be excessive and too much resource consuming for this premature stage and fail at this point might be enough to signal, not just the market but also potential investors, they lack the traction required to expand.

To sum up, it is important to underline that expanding a business to an external country has inherent and associated challenges and fixed costs and when companies attempt to expand globally, they will have to face and pay it for each one of them without the chance to ascertain whether they will be successful. Thus, experimentation presents itself as the most reasonable and appropriate strategy for this startup to start to scale.

Regarding the Top 6 countries that Freakloset should start to consider in its expansion strategy, please note that the proposed solution of this exercise underlies the construction of a matrix in which each variable outcome is summarized in a rate from 0 to 5 and finally quoted with a corresponding weight from 0-100% as showed in the table below. Other rational methodology can be applied although it may result in a slight deviation of the chosen countries.

According to the methodology applied, that granted a heavier weight to Digital Consumption (30%), a lighter to the Import Share of Consumption (10%) and similar weights for the remaining criteria (20%), the Top 6 is composed by the USA, Denmark, UK, Germany, Netherlands and France, respectively.

Countries	IMPORT SHARE OF CONSUMPTION	%	Average Import Price per Continent	%	Portuguese Export Target	%	Last 5 Year Variation	%	Digital Consumer Index	%	Total
USA	4	10,0%	3	20%	0	20%	5	20%	5	30%	3,5
Denmark	0	10,0%	5	20%	0	20%	4	20%	5	30%	3,3
United Kingdom	5	10,0%	5	20%	1	20%	-1	20%	5	30%	3
Germany	5	10,0%	5	20%	4	20%	0	20%	1	30%	2,6
Netherlands	0	10,0%	5	20%	3	20%	0	20%	3	30%	2,5
France	5	10,0%	5	20%	5	20%	-3	20%	2	30%	2,5
Norway	0	10,0%	5	20%	0	20%	0	20%	4	30%	2,2
Switzerland	0	10,0%	5	20%	0	20%	0	20%	4	30%	2,2
Sweden	0	10,0%	5	20%	0	20%	0	20%	4	30%	2,2
Australia	0	10,0%	4	20%	0	20%	0	20%	4	30%	2
South Korea	0	10,0%	1	20%	0	20%	0	20%	5	30%	1,7
Belgium	0	10,0%	5	20%	0	20%	0	20%	2	30%	1,6
Japan	4	10,0%	1	20%	0	20%	0	20%	3	30%	1,5
Spain	5	10,0%	5	20%	2	20%	-2	20%	0	30%	1,5
Italy	4	10,0%	5	20%	0	20%	0	20%	0	30%	1,4
Russian Fed.	3	10,0%	5	20%	0	20%	0	20%	0	30%	1,3
Canada	0	10,0%	3	20%	0	20%	0	20%	2	30%	1,2
Singapore	0	10,0%	1	20%	0	20%	0	20%	3	30%	1,1
Hong Kong	0	10,0%	1	20%	0	20%	0	20%	3	30%	1,1
Turkey	2	10,0%	4	20%	0	20%	0	20%	0	30%	1
U. Arab. Emirates	4	10,0%	1	20%	0	20%	0	20%	1	30%	0,9
Mexico	3	10,0%	3	20%	0	20%	0	20%	0	30%	0,9
China	1	10,0%	1	20%	0	20%	0	20%	2	30%	0,9
Philippines	3	10,0%	1	20%	0	20%	0	20%	0	30%	0,5
Vietnam	3	10,0%	1	20%	0	20%	0	20%	0	30%	0,5
Israel	0	10,0%	1	20%	0	20%	0	20%	1	30%	0,5
Brazil	1	10,0%	2	20%	0	20%	0	20%	0	30%	0,5
Taiwan	0	10,0%	1	20%	0	20%	0	20%	1	30%	0,5
Iran	2	10,0%	1	20%	0	20%	0	20%	0	30%	0,4
India	2	10,0%	1	20%	0	20%	0	20%	0	30%	0,4
Bangladesh	2	10,0%	1	20%	0	20%	0	20%	0	30%	0,4
Pakistan	1	10,0%	1	20%	0	20%	0	20%	0	30%	0,3
Indonesia	1	10,0%	1	20%	0	20%	0	20%	0	30%	0,3

The analysis of each of these countries allowed to identify a bundle of opportunities, bold in the case, that perfectly fit Freakloset’s value proposition.

**4.5 Imagine that Freakloset manages to find an investor up to invest today \$2,5M in the company. What equity stake would he demand today considering that he expects an exit in 5 years, with a return of 30%, at the future value of \$24M? Please note that more investors are expected to join future rounds and will acquire a total of 20% stake in Freakloset before the exit. What if the other investors have already acquired the 20% stake before this investor stepped in? How would this impact the stake he was about to ask for?**

The investor’s Equity Stake is given by the ratio of the amount invested (\$2,5M) and the post-money valuation ( $\$6,5M = 24 / (1+30\%)^5$ ), which equals 38,7%. However, if the investor realizes that more investors are about to enter the deal after him, he will anticipate the fact that his ownership will be diluted according to the amount acquired further by the other investors. Consequently, in order to invest today and ensure the original conditions, the investor will demand an equity stake of 48,3% ( $=38,7\% / (1-20\%)$ ) in order to be compensated by the dilution he will suffer upon the entrance of the other investors.

On the other hand, if the other investors have already acquired these 20% of stake before this investor’s proposal, the equity stake required will be exactly the same (38,7%) because the fact of slicing the pie previously to his entrance would not impact in anything the amount of equity he is about to ask for.

**4.6 As it was mentioned in the last chapter, there are not yet spared shares for an option pool purpose. Comment on this decision and indicate why are they considered so relevant to build value when companies are about to raise venture capital.**

An option pool, also known as employee stock option pool, is a percentage of the company’s equity shares that is kept safe for employees, as a mean to attract, compensate and retain new talent when they do not have enough capital and to give them an incentive to work according to the interests of the firm.<sup>12</sup> It is a manner to reward all those who have participated and contributed for the company’s success and a more robust try to attract new talent who are up to embrace and share the values and future challenges of the company.<sup>13</sup>

Option pools can often be a sensitive topic because many investors, and certainly venture capitalists, expect them to come out of pre-money valuation of the company and consequently at the expense of the founders.

The main reason is based on the fact that the more common stock companies offer, the less other stockholders’ options are worth. Consequently, if founders do not set aside a certain percentage of stake prior to someone else invests in, then every slice of the startup they promise to an employee as a stock option removes value from the investors' stake, making them lose a percentage of their potential return.

That's why investors almost always reject those terms and require an option pool prior to their investment, despite there is a new one raised on each round of investment. Consequently, being too rigid or intolerant on this matter may prevent the startups to successfully raise money from investors by pushing them away.

Hence, in order to protect themselves, founders should worry to focus on negotiating ESOP terms that work best for them.<sup>14</sup> This might include a detailed and accurate hiring plan based on the expected growth of the business and the definition of the explicit amount of stock they intend to issue for those new hires. This will make the option pool as smaller as possible so that no shares are left unissued. This should be left with little room to negotiate because investors will have the incentives to make them as large as possible because all the unused options that founders paid for will go to the next round’s option pool at their expense.<sup>15</sup>

Thus, as Freakloset has not distributed any equity yet, they did not have to worry about ESOP matters. However, as soon as they move to look for additional capital investments, they should highlight this point and start to take precautions to measure the eventual size of the option pool they will require so that their dilution does not turn a necessary vehicle of money to future investors’ pockets.

## Notes

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