The University Of Sheffield.

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Financial Planning for Start ups

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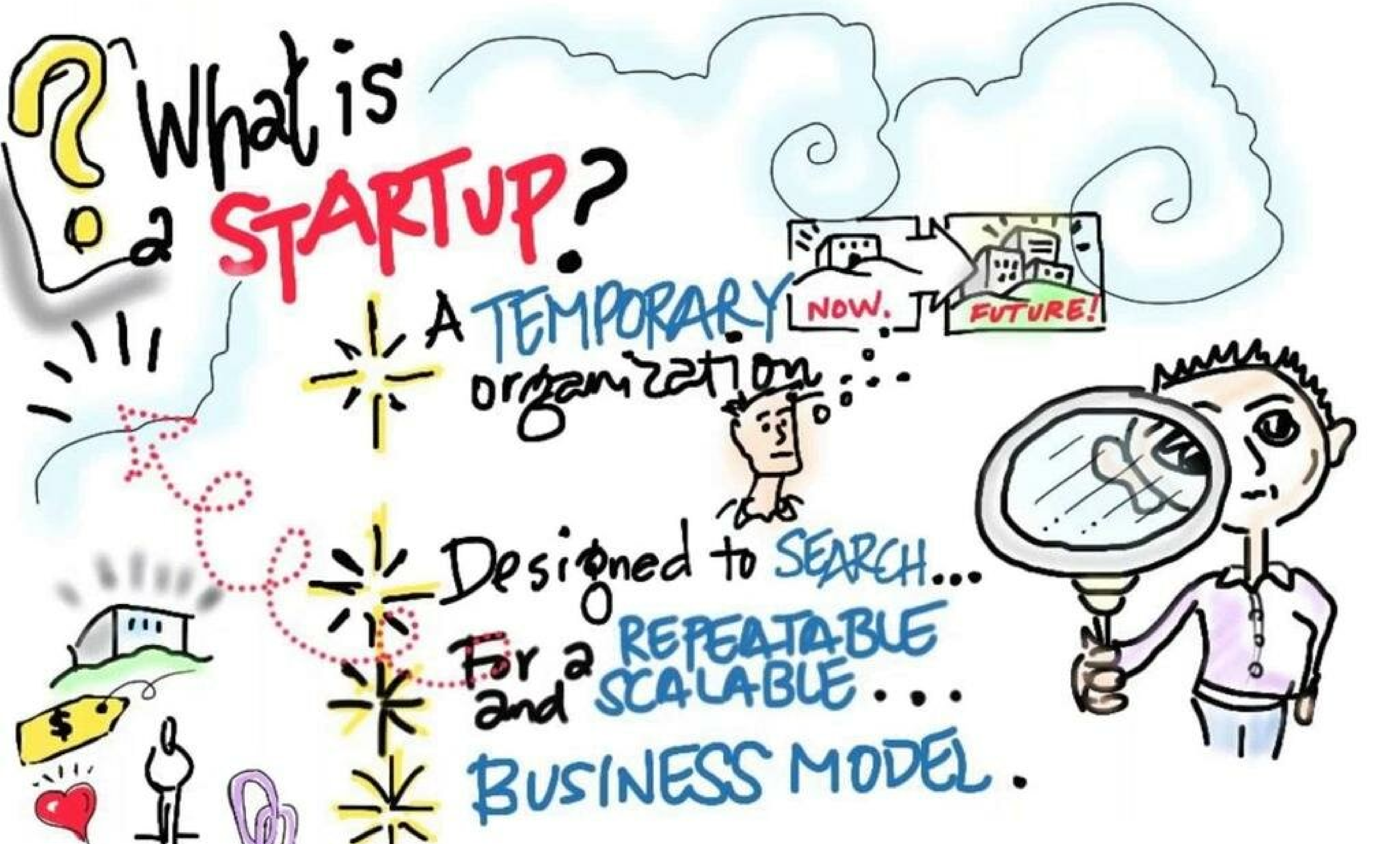

What is a STARTUP?
A TEMPORARY organization
NOW.
FUTURE!
Designed to SEARCH...
For a REPEATABLE and SCALABLE...
BUSINESS MODEL.
$

Overall Financial Attractiveness of the Venture

- The amount of capital invested
- The ROI timeframe
- The risks
- The alternatives for investing (opportunity cost)
- The alternatives for your time and effort

Financial attractiveness of the venture

Financial attractiveness of the venture

- Steady and rapid growth in sales during the first 5 to 7 years in a clearly defined market niche.
- High percentage of recurring revenue—meaning that once a firm wins a client, the client will provide recurring sources of revenue.
- Ability to forecast income and expenses with a reasonable degree of certainty.
- Internally generated funds to finance and sustain growth.
- Availability of an exit opportunity for investors to convert equity to cash.

Many Challenges

Financial Objectives of a Firm

- Profitability
  - Is the ability to earn a profit.
    - Many start-ups are not profitable during their first one to three years.
    - However, a firm must become profitable to remain viable and provide a return to its owners.
- Liquidity
  - Is a company's ability to meet its short-term financial obligations.
    - Even if a firm is profitable, it is often a challenge to keep enough money in the bank to meet its routine obligations in a timely manner.

Critical questions

Financial Challenges of Start-ups

Financial Challenges of Start-ups

- Lack of history to assess risk
- Lack of (industry) benchmark
- Lack of short-term profit potential
- Lack of liquidity
- Lack of financial credibility
- Potential misallocation of financial sources!!!!!
- Operational lock-in

Critical questions

- How much initial capital is needed?
- Sufficient capital is required to support the company until it turns profitable ?
- How long can the new business endure initial losses?
- How long will it take to make the business profitable?
- What kind of profit margin will eventually result from the product or service?
- What resources are available for financial support?
- How can the revenue and financial model be presented to investors for their involvement in the business?

Budgeted (Proforma) Financial Statements

A well-developed set of pro forma financial statements helps a firm create realistic budgets, build financial plans, and manage its finances **in a proactive rather than a reactive manner.**

Should be closely aligned with the business model.

Back and forth between financial plan and business model canvas.

Table: Start-up capital requirements

<u>Start-up Expenses</u>	
Expense 1	$0
Expense 2	$0
Expense 3	$0
Expense 4	$0
Expense 5	$0
Expense 6	$0
Total Start-up Expenses	$0
<u>Start-up Assets</u>	
Cash	$0
Other Current Assets (Inventory)	$0
Long-term Assets	$0
Total Assets	$0
Total Capital Requirements	$0

Balance Sheet

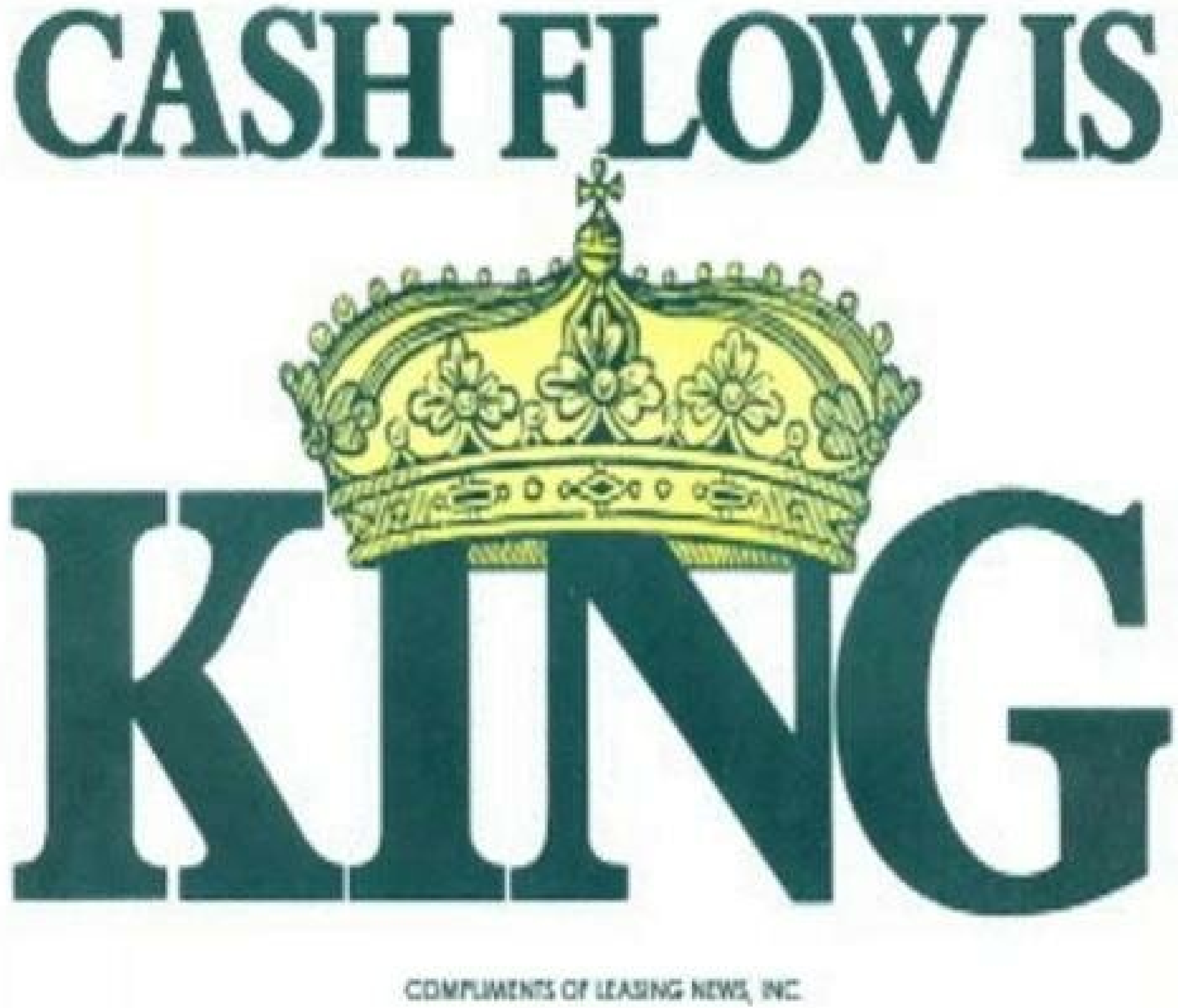
- WC Position
- Capital Asset Position
- Capital Structure (Sources of Capital0

Pro Forma Balance Sheet:

Current Assets	Current Liabilities
Fixed Assets	Long-term Debt
Intangible Assets	Equity
Total Assets =	T. Liabilities + Equity

The Balance Sheet

Non-cash Assets from Start-up table	$0
Cash Requirements from Start-up table	
Additional Cash ?????	$0
A/ Receivable	
Total Assets	$0
Liabilities and Partners' Capital	
Liabilities	
Current Borrowing	$0
Trade Payables	$0
Other Current Liabilities	$0
Long-term Liabilities (unlikely!!!)	
Total Liabilities	$0
Partners' Equity	
Additional Investment Requirement	$0
Total Equity	$0
Total Liabilities & Part. Capital	$0


CASH FLOW IS
KING
COMPLIMENTS OF LEASING NEWS, INC.


LAST
GAS
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EATH
LEY

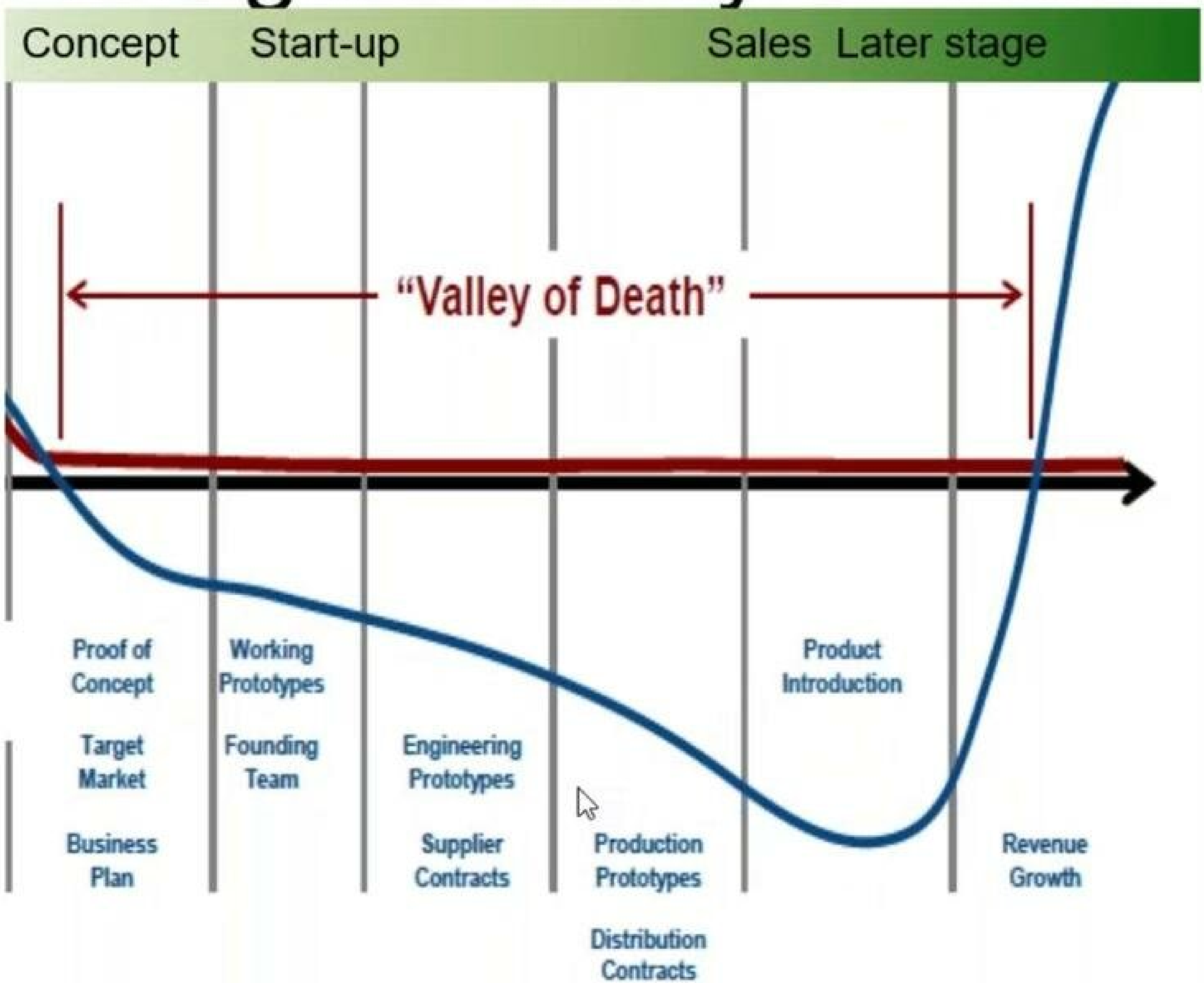
BASED ON ANALYSIS OF 101 STARTUP POSTMORTEMS

Top 20 Reasons Startups Fail

339 Startup Failure Post-Mortems

https://www.cbinsights.com/research/startup-failure-post-mortem/

Surviving the valley of death



Stage of venture development

Managing the cash in a start up

Bootstrapping Methods

Buying used instead of new equipment.	Coordinate purchases with other businesses.	Leasing equipment instead of buying.
Obtaining payments in advance from customers.	Minimizing personal expenses.	Avoiding unnecessary Expenses.
Buying items cheaply but prudently via options such as eBay.	Sharing office space or employees with other Businesses.	Hiring interns.

Managing the cash in a start up

- Cash is always tight in the start up phase
  - Initial start up capital is limited so rarely have lots of surplus cash
  - Launch delayed
  - Unexpected costs
  - Suppliers won't give credit

- How can the cash be stretched out
  - Defer salaries – founders work for free
  - Try and get things for free – use your network
  - Credit from suppliers
  - Find a way of generating revenue quickly – proof of concept, test customers, discounts for early adoption or early payment.

Prepare a Forecast of Cash Flow

- Month to month projection of receipts and disbursements(payments) activity.
- 1. Receipts from Sales. The detail from sales, the payment terms the company extends its customers, and the company's collection history
- 2. Other Receipts. Other receipts include bank loans, equity investments, tax refunds or any other inflows of cash
- 3. Disbursements from Expenses. The detail from expenses and the payment terms.
- (Excl. Depreciation)
- 4. Other Disbursements. This includes capital equipment acquisitions and payment of debt.
-

Cash receipts	$0
Cash receipts from sales	$0
Other cash receipts	$0
Total cash receipts	
Cash payments:	
To suppliers	$0
For operating expenses Excluding depreciation	$0
Other cash payments:	
Loan payments	$0
Acquisition of assets	$0
Start up cash expenses	
Net cash (positive /negative)	$0
Beginning cash	$ 0
Ending cash of the period	

Cash Management during a crisis

Cash Management during a crisis

- Plan weekly or even a daily cash flow
- Prepare a list of cash preservation measures

Ensure tight inventory control

- Ensure rapid cash collection and manage all receivables i.e. Bad debt % ,review credit policy
- Renegotiate/ extend payment terms with suppliers
- Review and track liquidity of key customers

Track customer behavior and implement client retention measures to preserve loyalty.

Income Statement (Profit & Loss)

- A typical income statement should include:
- Revenue (also called sales), followed by
- Cost of sales" or "cost of goods sold" (COGS).
- A services firm, may not have COGS.

Instead you may have Cost of Services.

- Revenue - COGS or CoS= Gross profit
- Gross Margin – Operating Expenses = Operating Proft (EBIT)

Income Statement

Pro Forma Income Statement

Revenue

- Cost of Goods Sold

Gross Profit Margin

- Operating Expenses

Net Income Before Interest and Taxes

- Interest

- Taxes

Net Income (Loss)

Income Statement

Sales		$0
Cost of Goods Sold (CoGS)		$0
Gross Profit		
Operating expenses :		
Selling, Marketing & Distrib.	$0	
General. % Admin.(G&A)	$0	
Total operating expenses	$0	
Operating profit(EBIT)		$0
Other revenue& expenses		
Net profit B/T		$0
Income tax rate%		$0
Net profit A/T		$0

What Costs does a business typically incur

- Office costs - rent, rates, electricity, gas, cleaning, security, coffee, postage etc
- Marketing
- Professional Fees eg Accountancy , Tax, Payroll Legal
- Insurances
- Employee salaries
- Initial Capital Expenditure - computers , office furniture

Software/ other intellectual Property

- Development Staff - Biggest cost
- Patent fees and legal costs
- Computer hardware/software

Web Business

- Web site design/maintenance - in house or outsource
- Hosting
- Domain registration
- Office Space
- Employees
- Fulfilment costs – postage, storage
- Customer relationship management

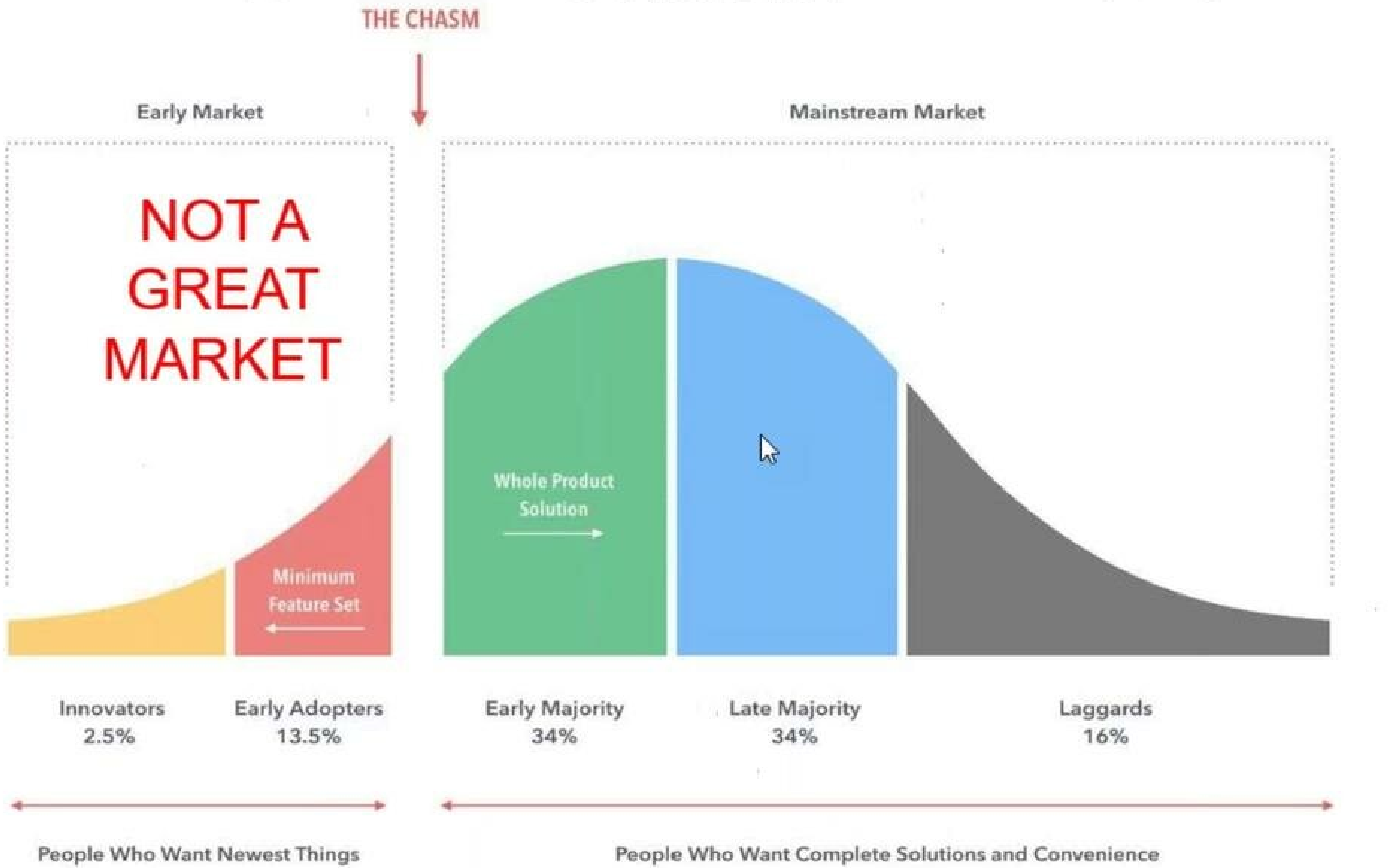
Critical Questions

- Does the company have a sense of how much of that market is obtainable?
- Are potential unit sales reasonable?
- Are sales prices reasonable? Is there any evidence to back them up?
- Are projected costs complete and reasonable?

How Many Will You Sell?

- What was the Market size and estimate of market share?,
  - Translate into the anticipated number of customers (as in 10% of a million-person market=100,000 customers)
- How many can your channel sell?
- How much will the channel cost?
- How many customer activations?
  - Revenue? Churn/Attrition rate? customers/?
- How much will it cost to acquire a customer?
  - How many units will they buy from each of these efforts?

The Challenge of Crossing the Chasm



What to Avoid in Financials

- Unreasonably high profit margins
- Revenue growing while all costs remain flat--line
- Ignoring timing impact of acquiring assets and incurring costs before revenue generation.

- Experiment with reasonable growth rates
- Must stack up to a reasonable share of reasonable market
- Treat revenue model, key resources, and cost model as areas of testable hypotheses
- Identify key data, test, and measure

The Behavior of Costs

- Variable costs
  - Vary with volume or operating activity
- Fixed costs
  - Remain fixed as volume changes
- Mixed costs
  - Exhibit characteristics of both variable and fixed costs

Contribution Income Statement

Sales	$0
Variable Costs	$0
Contribution Margin	$0
Fixed Costs:	$0
Operating profit	$0

Finding the Breakeven Point

$$\text{Sales} - \text{Variable Costs} - \text{Fixed Costs} = \$0$$

$$S - VC - FC = \$0$$

Using Contribution Margin to Determine the Breakeven Point

- Contribution margin (CM)
  - Is the amount that remains after all variable costs are subtracted from sales

$$S - VC = CM$$

- A product line's contribution margin represents its net contribution to paying off fixed costs and earning a profit
- Profit is what remains after fixed costs are paid and subtracted from contribution margin

$$CM - FC = P$$

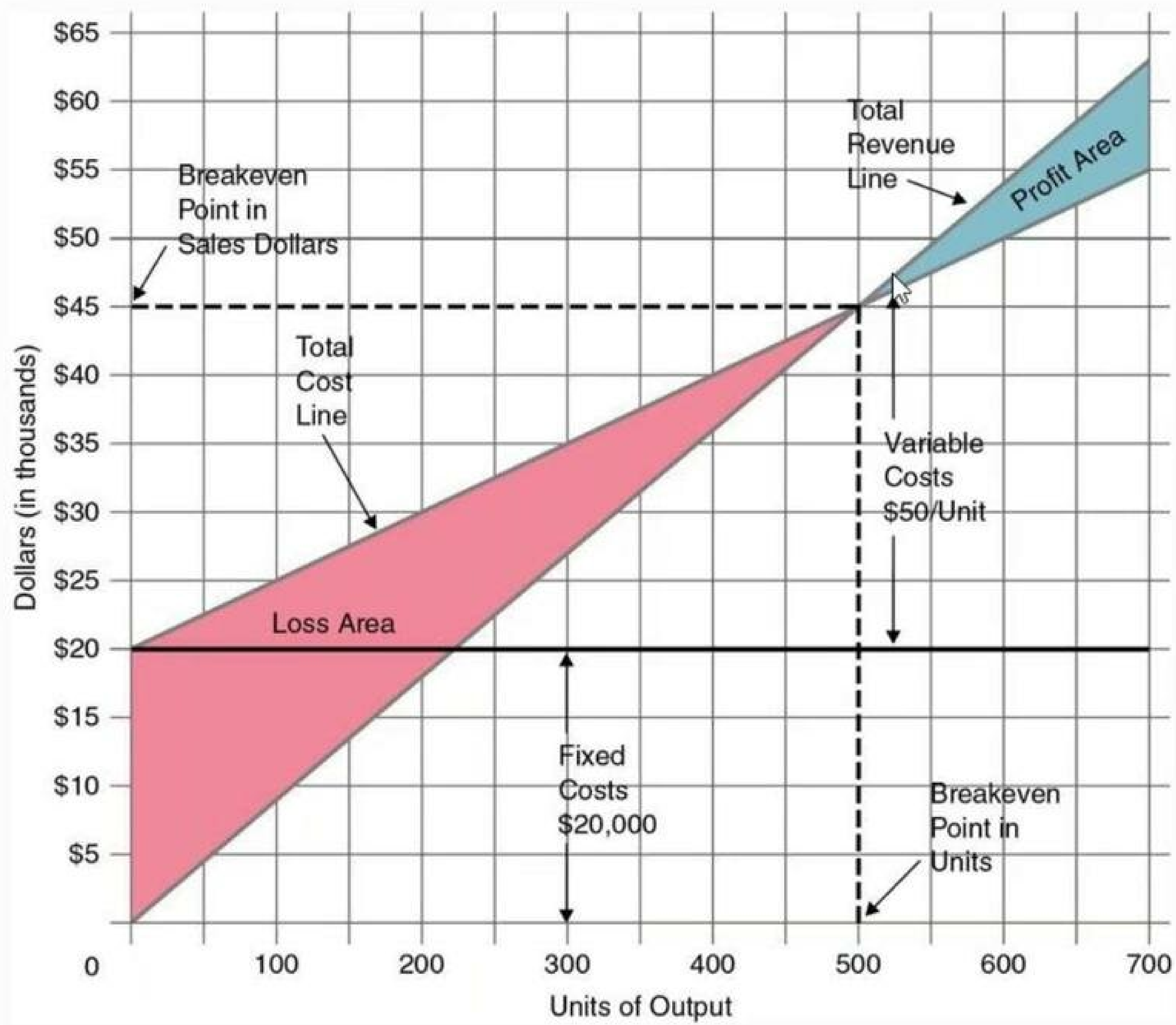
Break–Even point

- Can be expressed as the point where
- Contribution margin minus total fixed costs equals zero
- Contribution margin equals fixed costs

$$(\text{CM per Unit} \times \text{BE Units}) - \text{FC} = \$0$$

$$\text{BE Units} = \frac{\text{FC}}{\text{CM per Unit}}$$

Graphic Breakeven Analysis: Dakota Products, Inc.



"The numbers aren't working."

ASSESSING YOUR BUSINESS MODEL

SWITCHING COSTS

HOW EASY OR HARD IS IT FOR YOUR CUSTOMER TO SWITCH TO ANOTHER COMPANY?

RECURRING REVENUES

IS EVERY SALES A NEW EFFORT (TRANSACTIONAL) OR WILL IT RESULT IN FOLLOW-UP REVENUES AND PURCHASES?

EARN BEFORE YOU SPEND

ARE YOU EARNING MONEY BEFORE YOU ARE SPENDING IT (E.G. FOR PRODUCTION, PLATFORMS ETC.

ASSESSING YOUR BUSINESS MODEL

COST STRUCTURE

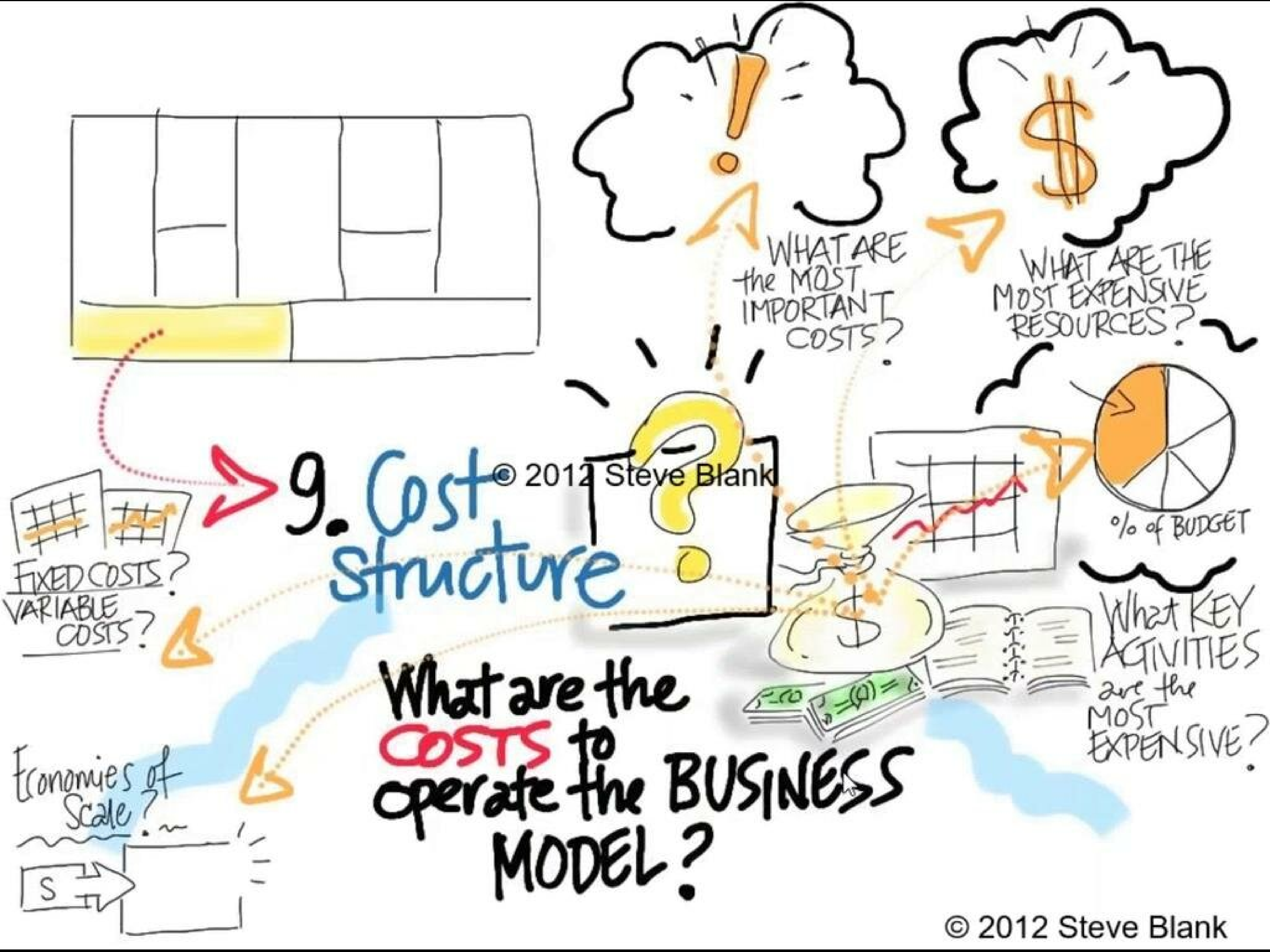
IS YOUR COST STRUCTURE SUBSTANTIALLY DIFFERENT AND BETTER THAN THAT OF COMPETITORS?

GETTING OTHERS TO DO THE WORK

HOW MUCH DOES YOUR BUSINESS MODEL GET CUSTOMERS OR THIRD PARTIES TO CREATE VALUE FOR YOU?

Creating a new business is challenging…

- You have to get the customer and market right
- You have to get the product right
- <u>You have to get the revenue model right</u>
- <u>You have to get the cost structure right</u>
- <u>You have to get customer acquisition right</u>
- You have to get the team right
- You have to get your timing right



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Business model Cost Structures:

- Cost Driven
- minimizing costs wherever possible

- Value-driven
  - Premium Value Propositions and a high degree of personalized service

Cost Structure

- Is the business more – cost driven or value driven?
- How are the costs configured?

- What are the fixed costs (salaries, rents, utilities)?
- What are the variable costs?

- Where could we benefit from economies of scale?

- Which key resources and key activities cost most?

- Where are the critical cost elements in this model?

9. Cost Structure-

- Cost Structure Characteristics:

Fixed costs	• minimizing costs wherever possible
Variable costs	• Premium Value Propositions and a high degree of personalized service
Economies of scale	• average cost per unit to fall as output rises
Economy of Scope	• Channels for different products and services may support multiple products.

Common approaches to pricing

Common approaches to pricing

Cost based

- Cost + markup
- Typically not a strategic way to price
- Driven by internal economics and not customer insight

Value based

- Based on buyer's perception of value (e.g. time saved, new efficiency created, etc.)
- Customers don't necessarily feel that they want to pay this way

Pricing Choices (2)

Pricing Choices (2)

- *Portfolio pricing*. Mix of high markups and some with low, depending on competition, lock-in, value delivered, and loyal customers
- "*Razor/razor blade" model*: part of the product is free or inexpensive; yet it pulls through repeat, highly profitable purchases on an ongoing basis
- *Subscription*: while now thought of a software strategy, the "Book of the Month Club" pioneered this for physical products
- *Leasing:* lowers the entry cost for customers. Provides constant earnings over a period of years

Pricing Choices (1)

- ***Cost-based pricing*****:** based on a multiple of actual product cost. Typically priced for maximum revenue/profit versus volume
- ***Value pricing*****:** based on the value delivered by the product rather than the cost itself
- ***Competitive pricing*****:** positions the product vs. others in its competitive set, typically in existing markets
- ***Volume pricing*****:** designed to encourage multiple purchases or users

Competition as an influence

Competition as an influence

Nature of Market

- Pure competition
- Oligopoloy
- Monopoloy

How they will react?

- What is their product?
- What are their costs and prices?
- "What pricing will make them feel the worst?"

Metrics Versus Accounting

The *Search* for the Business Model

The *Execution* of the Business Model

Scalable Startup → Transition → Large Company

Startup Metrics

- Customer Acquisition Cost
-Customer Lifetime Value
- Recurring revenue
- Monthly burn rate
- etc.

Traditional Accounting

- Balance Sheet
- Cash Flow Statement
- Income Statement