

Financial Modeling For A Startup

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The Funding Process

- Build a simulation of your business
- Prepare your investor documents
- Network to investors
- Make the pitch
- Negotiate a deal (Term Sheet)
- Close

Classic Mistakes



Classic Mistake #1

	2017	2018	2019	2020	2021
Sales	50,000	100,000	150,000	300,000	500,000
COGS	25,000	50,000	75,000	150,000	250,000
Gross Margin	25,000	50,000	75,000	150,000	250,000
SG&A	10,000	15,000	20,000	25,000	30,000
NPBT	15,000	35,000	55,000	125,000	220,000

Classic Mistake #2

- You provide a Pro Forma with just a P&L projection.

Profit Versus Cash Flow

P&L	2017	2018	2019	2020	2021
Sales	50,000	100,000	150,000	300,000	500,000
COGS	12,500	25,000	37,500	75,000	125,000
Gross Margin	37,500	75,000	112,500	225,000	375,000
SG&A	150,000	160,000	170,000	180,000	190,000
NPBT	(112,500)	(85,000)	(57,500)	45,000	185,000
Cash From Operations	2017	2018	2019	2020	2021
Net Income	(112,500)	(85,000)	(57,500)	45,000	185,000
Plus Depreciation	14,286	30,000	40,000	50,000	60,000
Plus Changes In Liabilities	7,500	8,000	8,500	9,000	9,500
Less Changes A/R	(8,333)	(16,667)	(25,000)	(50,000)	(83,333)
Less Changes In Inventory	(10,000)	(20,000)	(30,000)	(60,000)	(100,000)
Net Cash From Operations	(109,048)	(83,667)	(64,000)	(6,000)	71,167
Cash From Investing Activities					
Purchase of PP&E	(100,000)	(50,000)	(50,000)	(50,000)	(50,000)
Change In Cash Balance	(209,048)	(133,667)	(114,000)	(56,000)	21,167
Cash Balance	(209,048)	(342,714)	(456,714)	(512,714)	(491,548)

Items That Hide On Your Balance Sheet

- Receivables
- Capital Equipment & Software
- Prepaid Expenses (Insurance, Deposits)
- Inventory

Minimum Requirements

A complete set of Financial Projections always contains:

- P&L
- Balance Sheet
- Statement of Cash Flow

What Is A Financial Simulation?

- Models all of your revenues.
- Models all of your expenses.
- Revenues and Expenses are directly linked as much as possible.
- You can change any variable and instantly see the impact on every financial statement.
- Built from the bottom up:
 - Sale By Sale
 - Month by Month
 - Hire By Hire

Goals For A Financial Simulation

- Test options and optimize your go-to-market strategy:
 - Revenue Models
 - Distribution Strategies
 - Cost Structures
- Undertake a Sensitivity Analysis
- Determine your financing strategy
- Produce a Pro Forma for investors

Start With Your Revenue Model

- Consider different revenue models:
 - One-time purchase vs. subscription
 - Razor and razor blade
 - Free vs. Premium

How Are You Getting To Market?

- Direct Sales
- Manufacturers Reps
- Distributors/Resellers
- Franchise
- E-Commerce
- Acquisition

Model The Actual Sales Process

- Marketing & Sales expenses drive customer acquisition which drives transactions which drive revenues
- What are the time lags between sales & marketing expenditures and revenue generation?
- What are the critical conversion metrics that drive your sales pipeline?

Modeling Revenues: Excel Examples

- Build a profile for the economics of each transaction type and grow sales transaction by transaction.
- Show the expenses for priming the pump
- Always check Market Share!
- Direct Sales Model
- E-Commerce Model

Modeling Expenses: Excel Examples

- Build an expense model by line item and by functional department.
- Link headcount and other expenses to revenue transactions.
- Add in Overhead expenses.
- Don't forget the Balance Sheet:
 - Capital Expenditures
 - Inventory
 - A/R

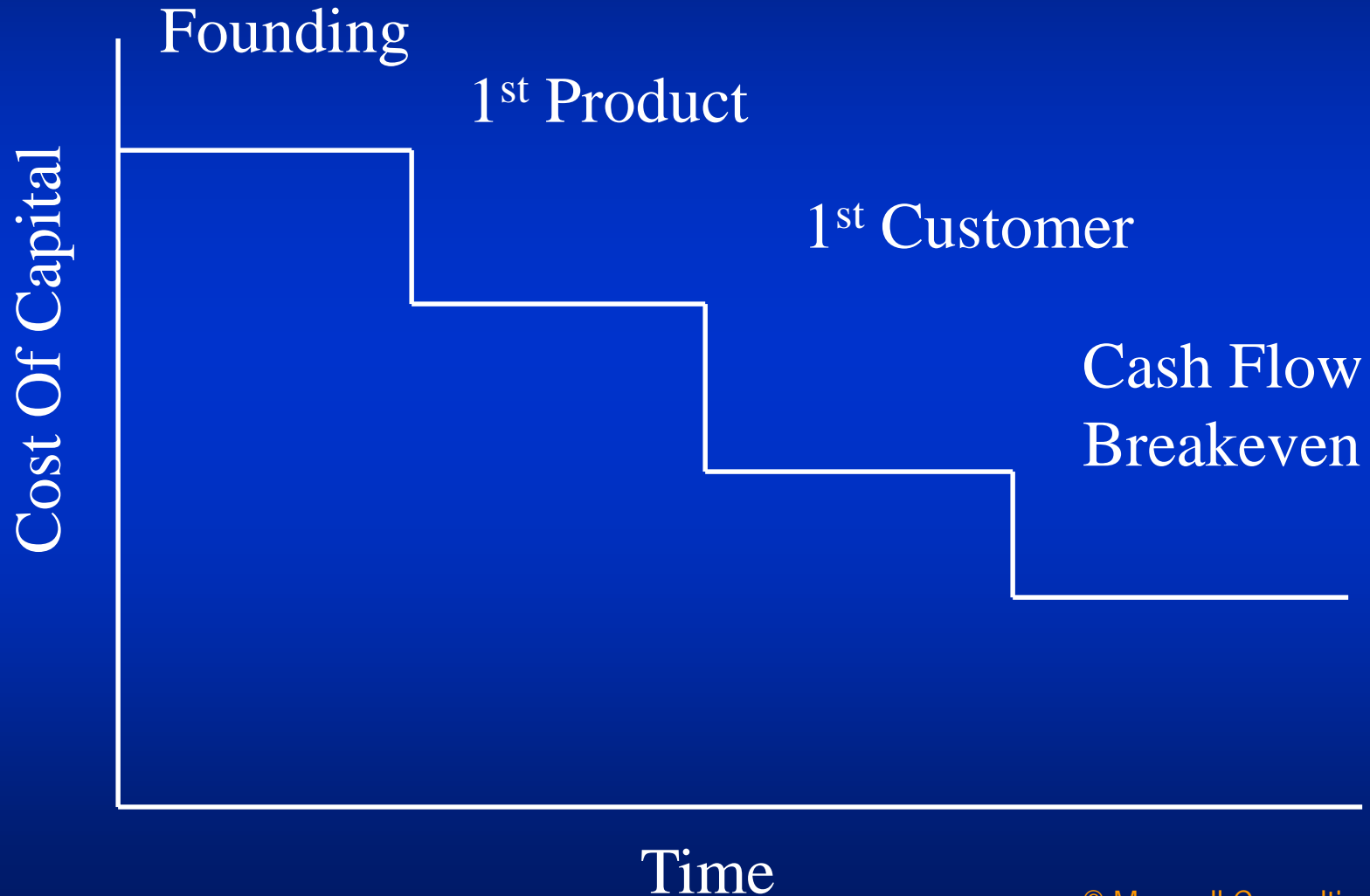
Complete All Financial Statements

- Use your business model to create:
 - P&L
 - Balance Sheet
 - Statement of Cash Flow
- Project out five years.
- Use your Statement of Cash Flow to determine how much cash you need.
- This will ensure you are financing ALL of your cash needs.

Analyze The Growth Ramp

- Play with different growth rates
- Determine if faster growth consumes:
 - More cash to reach cash flow breakeven
 - Less cash to reach cash flow breakeven
- Raise more money up front if indicated.

The Risk Breakpoint Waterfall



Taking On Investors: The Pros

- Option to play at all; cash to grow
- Deep Pockets: follow-on investment & debt
- Credibility & credit rating
- External discipline: the board (checks & balances)
- Strong network benefits for sales, recruiting & resources

Taking On Investors: The Cons

- The Golden Rule: He who has the gold rules
- The gun to your head: relentless growth
- Conflict of interest: the Portfolio Effect
- Spending gets out of control
- Liquidity Event Horizon
- Myths & realities of replacing the CEO

Sizing Up Investors

Type	Angels	VC's
Professionals: ROI-oriented	✓	✓
Experts & Insiders	✓	✓
Missionaries	✓	✓
Status Seekers	☠	N.A.
Entrepreneurial Wannabees	☠	☠

Timeframe To Raise Capital

	Weeks
Build Financial Model	4
Prepare Investor Docs	6
Identify/network to investors	8
First round meetings	2
Second round meetings	2
Due Diligence Process	4
Receive Term Sheet	2
Negotiate Term Sheet	2
Lawyers negotiate/draft docs	4
Close (signing & funding)	2
TOTAL	36

Equity Valuation: The Theory

- Net Present Value of discounted cash flow
- P/E Multiples for Comparables
- Acquisition Prices for Comparables
- Subscriber-Based Valuation

Equity Valuation: The Reality

- VC Portfolio Approach
- The Barber Model (what percentage haircut do your revenue numbers get?)
- Set the bar with the credibility of your projections
- Market pricing: get multiple term sheets
- Impact of cyclical factors
- Importance of cash reserves in negotiations

Traps To Avoid

Q: "What are you thinking of for valuation?"

A: "That's your job. My job is to get as many term sheets as possible and pick the best one."

Q: "Who else are you talking to?"

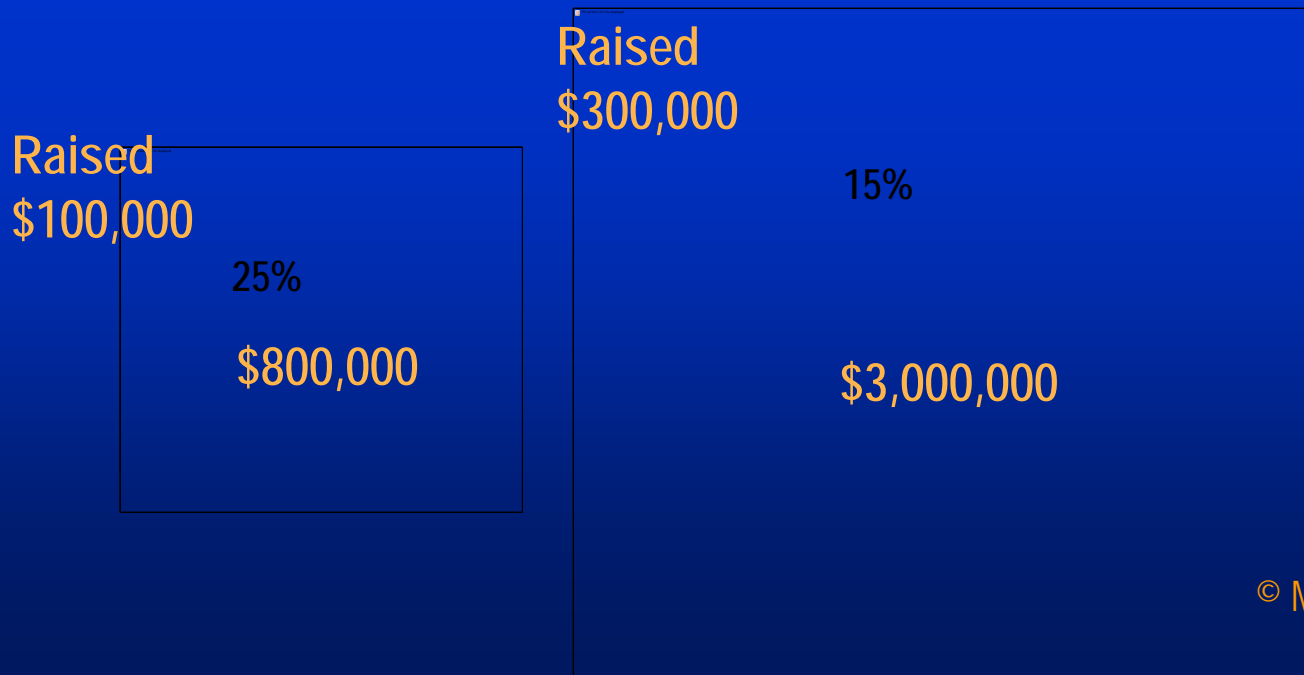
A: "A small group of carefully targeted funds. But we prefer to keep our discussions confidential."

Valuation Math

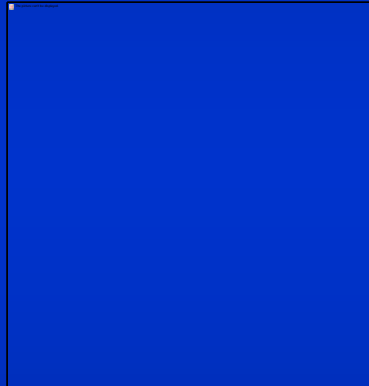
- 1,000,000 shares outstanding, fully diluted
- Term Sheet offers \$1 million at \$3.00 a share
- Pre-Money Valuation is $1,000,000 \times \$3.00 = \$3,000,000$
- 333,333 new shares issued to investors at \$3.00
- Post-Money Valuation is $1,333,333 \times \$3.00 = \$4,000,000$
- Investors took a 25% share of the company

The Gold At The End Of The Rainbow

- Management's goal is NOT to end up with the highest possible % of the company.
- Managements goal is to end up with the highest possible dollar payout.



Open Discussion



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