

Reader Exercises

Now it is your turn to develop your own financial projections. To guide you through this process, you can find financial templates for various types of companies on our textbook Website.

Step 1: Develop a Granular Projection of Revenue

- Determine the format desired by your professor. We recommend monthlies for the first two years, or until you become cash flow positive. Afterward, annual projections are fine. Your professor may just want annual projections for all five years. Be sure to ask.
- Run through various scenarios on the number of customers, the products and services you are selling, and the unit prices for those commercial offerings. Don't forget to start on a whiteboard first before becoming too heavily engaged on a spreadsheet. Spreadsheets sometimes lead individuals into blind replication of numbers. Investors will challenge you on all your numbers; they do not appreciate thoughtless financial projections. Be realistic about customer ramp-up. Think hard about concrete objectives that lead to the "scaled-up" revenue potential that you determined in the Reality Check. (We think of that as a revenue target for the fifth year of operations.)
- Also think about recurring revenue from existing customers, as well as new revenue from new customers. Build these into your projections as well.
- If you are a products company, think about any services that you might offer with your products (if that is the case), the pricing for those services, and how these ramp up over time. Show these as separate line items. Some professors may ask you to double-check your granular revenue projections against a "top-down" projected share of market approach. In other words, what percentage of the target market do your revenue projections represent, particularly in Year 5? Is that in any way realistic? Is it insufficiently ambitious? If you think your venture's financial requirements put you into the league of institutional venture capital, then these are questions you will be asked and for which you will need reasonable answers.

Step 2: Develop a Pro Forma P&L

Summarize your revenue projections into the top portion of the projected P&L. Then think through your cost of goods. Try to do a "bottoms-up" estimate of the materials and conversion or assembly cost on those materials. For benchmarks, the COGS of manufactured products often come in at 30% to 40% of revenue; for software-based businesses, COGS are far less, from 2% to 15% of revenue; and for labor-intensive services, often at 35% of revenue. Then apply the guidance in this chapter to carefully consider your various operating expenses.

More generally, most investors know that any numbers beyond the first two or three years in a projected P&L are largely speculation. However, the fifth-year estimation remains important because it gives some sense of potential exit value as a multiple of revenue and profit. Once again, internal corporate ventures can satisfy with annual P&L projections. Take your best shot, remembering the "scaled-up" revenue projection you determined in the Reality Check.

Step 3: Develop a Cash Flow Projection

Cash flow is important to entrepreneurs and investors—where every dollar often means the difference between paying yourself a modest salary, or not, during the startup period. This is where you take your learning from accounting classes and apply it to your venture. These are the key questions to consider:

- What are the adjustments to working capital? The big items here are to adjust working capital for accounts receivable (increase working capital), inventory (increase working capital), accounts payable (decrease working capital), taxes (decrease working capital), and any prepaid expenses (decrease working capital).

- Are there adjustments due to fixed capital expenditures, such as spending money on machines of some sort?
- Are the increases to cash due to any short-term borrowing, such as amounts taken from a line of credit with a commercial bank or longer-term commercial notes?
- Are there any infusions of capital from investors?

The last point might lead some to question the extent to which to include seed, Series A, and successive rounds of financing in the cash flow projections. Figure out how much you need to cover cash shortfalls and to meet required investments in people, plant, and equipment. We suggest that you include those rounds of financing needed to (a) get your product to market, and (b) get your company to a cash flow positive footing. That might be \$200,000 right in the beginning to complete development, \$2 million in six months to build a sales force, and \$4 million in two years to scale nationally. Often, services can be cash flow positive from the start, so the amount of money required is to hire the people and buy or lease the computers and office space needed to start delivering those services. Once again, your business model should be driving these projections.

Step 4: Develop a Balance Sheet (Optional)

Balance sheets are a snapshot of performance, year by year. Venture investors expect to see a Balance Sheet as part of a complete set of financial statements. However, unless you are planning on debt financing during the first year or two of operations, it is unusual to see an equity investor focus on the Balance Sheet.

Step 5: Establish Financial Goalposts

- *Startup costs.* These come directly from your Cash Flow Statement, specifically from the month-by-month breakdown of operating expenses and capital investments in plant and equipment. An investor will dig in to the cash flow projections to ask a million questions, one of which will be to pinpoint “startup costs” over the first six months to get to “alpha” or “beta” tests and the “launch” costs of successfully introducing a new product, system, or service to market. Remember, if you have included seed- or Series A-type infusions of cash as part of the cash flow projects, you should subtract these first before summing up your various cash needs to achieve specific milestones. Obviously, the purpose of those funding rounds is to cover the cash shortfalls on the path to profitability.
- *The time to first dollar.* When the business becomes “real”, this information comes right from monthly projections of revenue.
- *The time to first profit.* When the business achieves true investor value, this, too, can be found in the projected P&L.
- *First-round and anticipated second-round financing amount.* (That is, seed funding and Series A.) If you are a corporate entrepreneur, do this for the startup capital and then the growth capital to scale your internal venture. As mentioned earlier, these rounds of financing are typically shown in the projected Cash Flow Statement and carried on to the Balance Sheet.
- *Potential valuation for exit.* (For example, the value of the company as an acquisition by a larger concern.) Use an industry standard multiple for your project valuation—say, after five years. If you cannot find a standard multiple, use the following until you do: for products, 2X revenue and 4X EBITDA; for software, 4-5X revenue and 8-10X EBITDA; for pure services, 1.5X revenue and 3X operating profit.

It is hard to develop a comprehensive set of financial projections alone. And rarely can they be done quickly. Set aside two or three solid working days to accomplish the steps outlined above. And take the opportunity to share your results with your advisers—including your professors. You need to be challenged on the numbers by trusted, friendly parties before running the gauntlet with professional investors.

For when it comes to the numbers associated with a business plan, the term *root canal* is a fair description of the type of probing that VCs and others will perform on your projections. The three questions that will run continuously through their minds will be:

1. Are the sales projected for the business both sufficient and based on a realistic revenue model?
2. How much will it really cost to get this business to scale? For example, is it really a million dollars, as the entrepreneur suggests, or is it really two or three million?
3. And if this business works as planned, what is the possible exit valuation based on performance in Year 5? More specifically, a million invested today will be worth how many millions down the road?

Your financial projections must answer these questions. While many investors get excited about new Venture Concepts, business model innovations, and the passions and experience of a venture team, *all investors* drop their smiles and become all too serious when it comes to the numbers. Prepare to defend your numbers, not just once, *but again, again, and again*.

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