CAYENNECONSULTING

Budgeting & Forecasting for Startups

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Agenda

- **Why Do You Need to Know/Do This?**
- **Financial Statements 101**
- **Quick & Dirty Forecasts**
- **Key Concepts & Issues**
- **Implementation**
- **Resources**

What are Budgets & Forecasts?

- **Future Expenses**
  - **Budget**

- **Complete Picture of Future Performance:**
  - **Financial Forecast**
  - **Financial Projections**
  - **Financial Model**
  - **Pro Forma Financials**

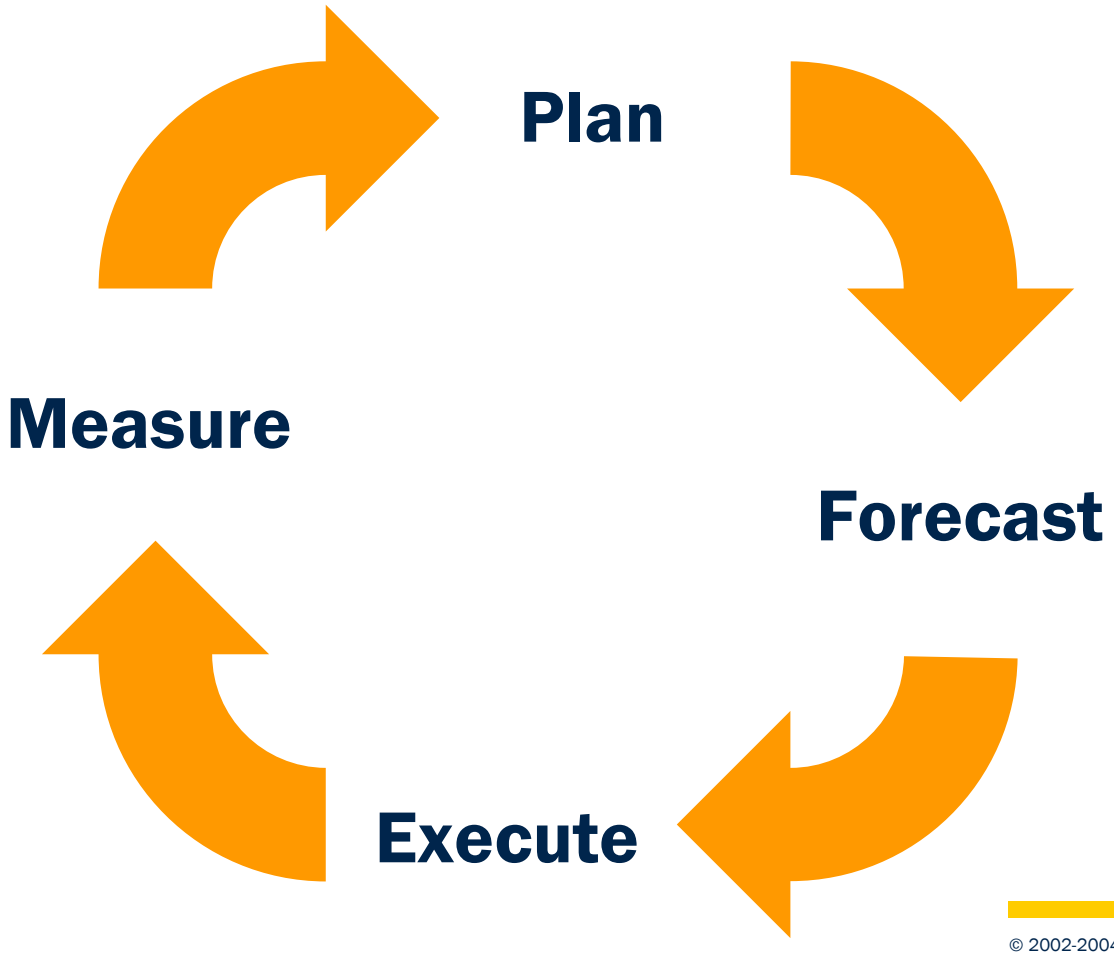
} **Roughly the same**

Why Budget & Forecast?

- Feasibility Analysis
  - Develop Business (Revenue) Model
  - Think Through Assumptions
  - Identify Resource / Capital Needs
- Fund Raising Tool
  - Demonstrate Potential to Investors & Lenders
- Management Tool
  - Report Card: Milestones & Accountability
  - Identify Risks
  - Measure & Benchmark Drivers / Metrics

Forecasting as Process

"You can't manage what you can't measure."



What VCs Want to See

- You know what you're talking about
- A potential home run
- You'll invest their money wisely
- 4-5 year forecast
- $50-100 million revenues by Year 5
- $5-20 million investment spread out over several rounds
- Significant revenues SOON if not NOW
- Neither conservative nor aggressive

What Bankers Want to See

- You know what you're talking about
- Forecast for the period of the loan
- You'll be able to repay the loan
  - Risks are mitigated
  - Financial ratios are conservative
  - Hard assets are available as collateral
  - Personal credit (you'll probably need to guarantee the loan)
- Revenues SOON if not NOW

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When?

- **Actual: What really happened**
- **Forecast: What you hope will happen**
- **Forecast vs. Actual: How well you did compared to what you thought might happen**

Core Financial Statements

- **Three related statements:**
  - **Income Statement (Profit & Loss)**
  - **Balance Sheet**
  - **Cash Flow Statement**

- **Details depend on:**
  - **Market / Industry**
  - **Business model**
  - **Intended audience**

Income Statement

- Measures profitability over a period of time (month, quarter, year)
- Don't confuse profit (or loss) with cash

Income Statement Example

Acme Widgets – Income Statement

October 2004 – All figures in $000

1. **Gross Revenues**	**1,000**	**100.0%**
2. Less: Cost of Goods Sold	600	60.0%
3. **Gross Margin**	**400**	**40.0%**
4. **Operating Expenses**		
5. Salaries & Benefits	200	20.0%
6. Rent & Utilities	20	2.0%
7. Other Expenses	40	4.0%
8. Depreciation	28	2.8%
9. Total Operating Expenses	288	28.8%
10. **Net Income Before Interest & Tax**	**112**	**11.2%**
11. Net Interest Income (Expense)	(5)	(0.5%)
12. Tax Expense	30	3.0%
13. **Net Income (Loss)**	**77**	**7.7%**

Balance Sheet

- Measures general financial health at a point in time
- Assets: What you got
- Liabilities: What you owe
- Equity: What's left over (for owners)
- Basic Accounting Equation:

$$\text{Equity} = \text{Assets} - \text{Liabilities}$$

$$\text{Assets} = \text{Liabilities} + \text{Equity}$$

Balance Sheet Example

Acme Widgets – Balance Sheet

All figures in $000

		9/30	10/31	Change
1.	**Assets**			
2.	Cash & Equivalents	500	335	(165)
3.	Inventory	1,000	400	(600)
4.	Accounts Receivable	500	1,000	500
5.	Property, Plant, Equipment	1,000	1,000	0
6.	Less: Accumulated Depreciation	(500)	(528)	(28)
7.	**Total Assets**	**2,500**	**2,207**	**(293)**
8.	**Liabilities**			
9.	Accounts Payable	400	0	(400)
10.	Debt	1,000	1,000	0
11.	Deferred Taxes	0	30	30
12.	**Total Liabilities**	**1,400**	**1,030**	**(370)**
13.	**Equity**	**1,100**	**1,177**	**77**
14.	**Total Liabilities & Equity**	**2,500**	**2,207**	**(293)**

Cash Flow Statements

- Changes in cash over a period of time:
  - Where cash comes from
  - Where cash goes to

- Three types of cash flow statements:
  - Statement of Cash Flows (GAAP)
  - Statement of Sources & Uses
  - Statement of Receipts & Disbursements

Receipts & Disbursements Example

Acme Widgets – Cash Receipts & Disbursements

October 2004 - All figures in $000

1.	**Starting Cash**	**500**
2.	**Receipts**	
3.	Collections	500
4.	Financings	0
5.	Total Receipts	500
6.	**Disbursements**	
7.	Payments to Suppliers	400
8.	Salaries & Benefits	200
9.	Rent & Utilities	20
10.	Other Expenses	40
11.	Interest Expense	5
12.	Tax Payments	0
13.	Total Disbursements	665
14.	**Net Increase (Decrease) in Cash**	**(165)**
15.	**Ending Cash**	**335**

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Revenues & Sales Headcount

- Start with Year 5 Revenues investors want to see
- Each prior year is 40% of following year
- Estimate reasonable revenue per salesperson for each year, depending on your industry
- Calculate number of salespeople required

	Year 1	Year 2	Year 3	Year 4	Year 5
Gross Revenues ($000)	1,280	3,200	8,000	20,000	50,000
Revenue Per Salesperson	427	640	750	1,000	1,250
Salespeople Required	3	5	10	20	40

Total Headcount Forecast

- How many of everybody else will be needed to support this level of sales?

	Year 1	Year 2	Year 3	Year 4	Year 5
Headcount					
Sales & Marketing	3	5	10	20	40
General & Admin	1	2	3	5	10
R&D	2	2	3	5	10
Operations	1	3	5	10	20
Total Headcount	7	12	21	40	80

Other Assumptions

- **Gross Margin Assumptions**
  - $2,500 average sale price per widget
  - $1,500 average COGS per widget

- **Operating Expense Assumptions**
  - $125,000 average operating expense per employee (salaries, rent, travel, etc.)
  - $2,500,000 in non-salary startup expenses

Quick & Dirty P&L Forecast

	Year 1	Year 2	Year 3	Year 4	Year 5
Widgets Sold	512	1,280	3,200	8,000	20,000
Total Headcount	7	12	21	40	80
Gross Revenues ($000)	1,280	3,200	8,000	20,000	50,000
Less: COGS	768	1,920	4,800	12,000	30,000
Gross Margin	512	1,280	3,200	8,000	20,000
Operating Expenses					
Startup Expenses	2,500				
Other ($125K x Headcount)	875	1,500	2,625	5,000	10,000
Net Income Before Tax	-2,863	-220	575	3,000	10,000

Sanity Check

	Year 1	Year 2	Year 3	Year 4	Year 5
Widgets Sold	512	1,280	3,200	8,000	20,000
Total Employees	7	12	21	40	80
Total Salespeople	3	5	10	20	40
Gross Revenues ($000)	1,280	3,200	8,000	20,000	50,000
Per Employee	183	267	381	500	625
Per Salesperson	427	640	750	1,000	1,250

Depending on the industry, revenue per employee in Years 4 and 5 might be a bit high

What If...

- Revenue per salesperson tops out at $1 million (or whatever the average is in your industry)?
- Average opex is $150,000 per employee?
- Startup expenses are $5 million?
- Product isn't ready to ship until Year 2?
- Gross margin shrinks over time?
- More operations personnel are needed?
- You add advertising to the mix?
- You introduce a new product in Year 3?

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Assumptions

- Foundation on which all else is built
- Not all assumptions are created equal
- How do you justify the material assumptions?
- How will material assumptions change over time?
- What happens if you are wrong?

Startup Laws

First Law of Startups:

Everything takes longer to do than you think it will

Second Law of Startups:

Everything costs more than you think it will

Third Law of Startups:

No entrepreneur thinks of everything

What are startup costs?

- Everything you need to spend:
  - A. In the first year
  - B. Until you are profitable
  - C. Until you are cash flow positive
  - D. All of the above

- Answer: D.
  Make sure you and your audience are on the same page

Forecasting Sales

- What drives sales in your market?
  - Salespeople?
  - Distributors?
  - Advertising?
  - Search engines?
  - Referrals?
  - Location?
  - Price?
  - Coupons?

If you have a sales force...

- Sales force productivity
  - Learning curve (and impact of turnover)
  - Market acceptance
- Sales cycle for your target customer
- Impact of discounts and competition

Cost of Goods

- Marginal cost of most goods are inversely proportional to quantity
- Marginal cost of most technology goods go down over time
- Includes total cost of getting a product ready for sale (packaging, shipping, etc.)
- Every industry is different

Operating Expenses

- Most operating expenses are roughly proportional to headcount:
  - Salaries, benefits, employment taxes, furniture, computers, rent, supplies, utilities, training, travel, meals, telecommunications, training, dues & subscriptions, etc.
- Others may or may not be:
  - Professional services, subcontractors, advertising, trade shows, etc.
  - Market-specific: Clinical trials, patents, etc.

Cash vs. Accrual Accounting

- Cash accounting: record income and expense at the time cash trades hands

- Accrual accounting: record income and expense over the period of the transactions (cash may or may not change hands at the same time)

Matching Principle

- Record expenses over the period they generate revenues

- Example: depreciation
  - Machine with an expected life of 10 years
  - Depreciate cost over 10 years

Cash Cycles

- Your forecast assumes customers pay in 30 days…
- In reality, they pay in 90 days…
- Meanwhile, your suppliers send Guido to collect in 30 days…
- You're profitable, but bankrupt!

Benchmarking

- Compare yourself to others in your industry:
  - Revenue per employee
  - Revenue per salesperson
  - Employees per customer
  - Gross margin
  - Expense categories as % of revenues
  - Financial ratios
  - Industry-specific metrics

Sensitivity Analysis

- Adjust each major assumption by 10% and examine impact on:
  - Revenues
  - Profit
  - Cash needs
- Focus on validating the assumptions that have the greatest impact

Make it right

- Assets = Liabilities + Equity
- Reconcile P&L, balance sheet, & cash flow
- Consistent (and correct) use of cash or accrual accounting
- Consolidate correctly

Hallmarks of a good model

- Easy to understand
- Simple (80/20 rule)
- Free of basic errors
- Well documented assumptions
- Easy to update

Be Prepared

- Startup expenses will be scrutinized
- Know your industry's metrics and benchmarks

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Implementation

- From scratch with a spreadsheet
- Starting with a spreadsheet you find via Google
- Software like Business Plan Pro
- Outside accountant or consultant

Reality

- Unless you have a very strong finance and accounting background, you will have a difficult time creating financials that are acceptable to VCs

- Focus your efforts on validating assumptions, and use an accountant or other consultant to develop the model

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Financial How-To

- Google
- Brode.net
- StudyFinance.com
- SBA.gov/training/courses.html

Public Company Information

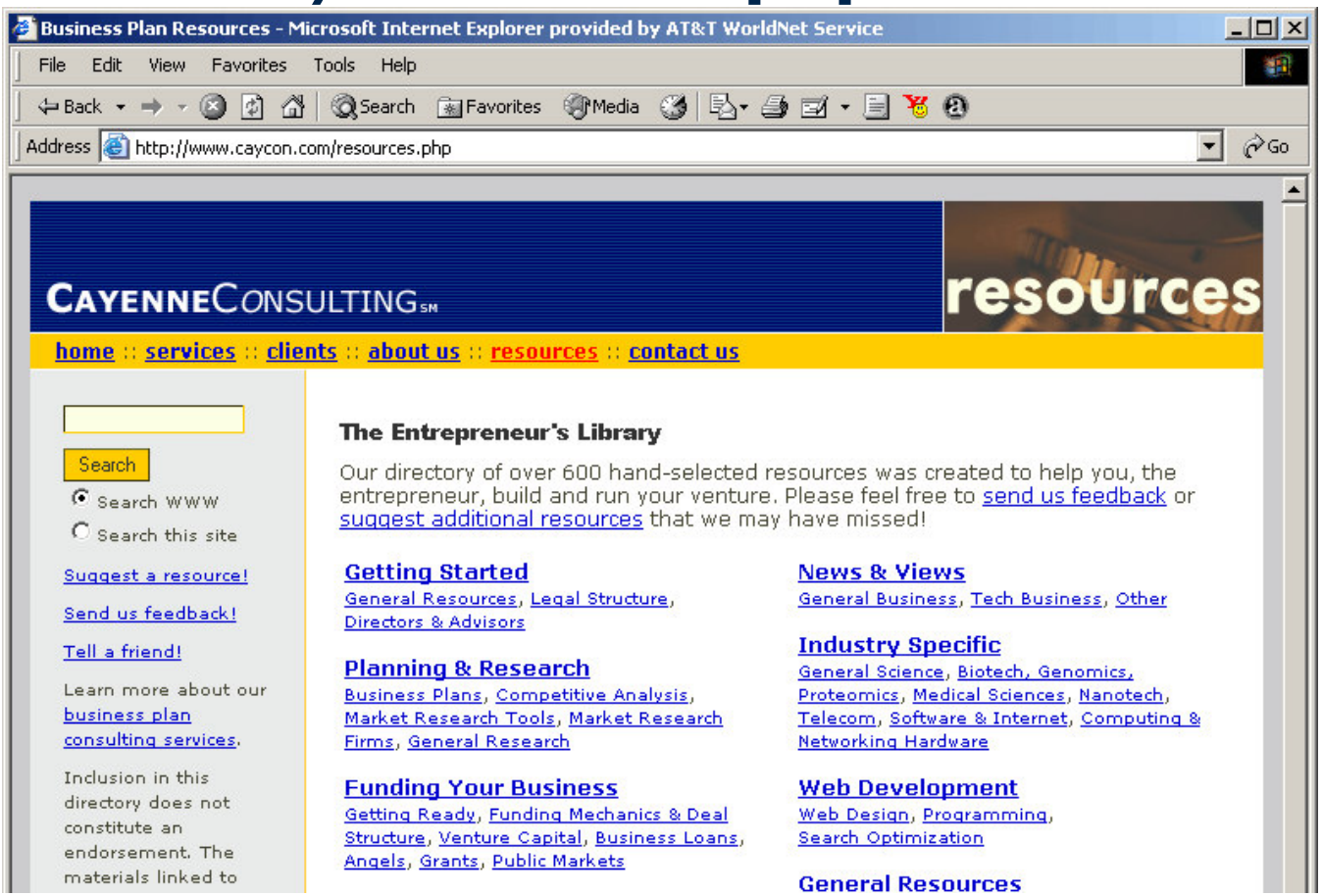
- Annual (10-K) and quarterly (10-Q) SEC reports; Registration Statements (S-1):
  - FreeEdgar.com; finance.yahoo.com
- General corporate information
  - Company websites
  - finance.yahoo.com
  - hoovers.com
- Investment bank research reports
- Credit rating agencies (Moody's, S&P)

Industry Information

- Investment bank research reports
- Market research firm reports
- Google
- BizStats.com
- Fuld.com (Intelligence Index & CI Tools)
- Economy.com
- Census.gov

Entrepreneur's Library

caycon.com/resources.php



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heat up your business

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