2021-12-14 TENFL Preparing Financial Projections Q&A

Segment 1 -- Financial Projections

Hall Martin: Today we're going to be talking about preparing financial projections.So the two key documents you need to go out in a fundraise is a pitch deck, which we talked about last month, and your five-year financial projections, which we're going to talk about today. And the purpose of these financial projections is not to predict the future, but rather to demonstrate you know what you're going to do with the funds raised, and you know enough about your business, you can make some meaningful estimations of costs and revenues and so forth. And again, people sometimes say I don't want to predict the future, so I'm not going to write down anything, but what the investor wants to know is, what exactly are you envisioning the future to look like, how fast is the growth rate, when are you going to go cash-flow positive. At a very high level, they're looking to see what your expectations are, if you achieve the fundraise. And the next thing you'll see is that they'll be looking at the financials to figure out how well you know your business. Sometimes I get financial projections where year one we're going to generate $1 million, year two we're going to generate $2 million, and so forth. Well, that doesn't show any reality to the marketplace, that's just guessing. And then sometimes I look at expenses, and it's all over the map. And the more detailed those things are, the more you're demonstrating you know your business, and the more convincing your startup will be to a prospective investor. And the final thing is, it becomes an operational tool – when the fundraise is over, if you have a good financial projection, it will help guide your business as you go forward. So it's worth putting one together now, as you go down the path of raising funding and growing your business, because you're going to need more of that as you go forward. And so, these are the things that we're going to be talking about today, a typical financial projection spans three to five years; if you've got a year of history behind you, put that in there, if you – and then put this year, and then put the next three years. So it's a five-year window. It's one year behind the current year, and three years going forward is the ideal case. If you don't have a year behind, you, well then, start with this year, and go forward with four more years as best you can with it.

So the other thing you want to put into your financial projections aside from your revenue and your costs are a few key metrics such as sales growth, the gross margin, and the profitability are good ones to put in there. And then, as your financials go forward, and forecast turned into reality, those metrics there will track how you're doing on key metrics, and investors allowed to see metrics like that, because they want to understand – they want you to know that you are actually measuring key performance indications, and they can look at that to see how well you're doing with it. So in addition to the costs and revenue, make sure you put the KPIs in there as well. You don't have to have a lot of them, three or four is plenty for communicating to the investor. And as you go forward, you may want to add more just for your own benefit as well.

And so, the two components you want to start with is revenue and cost of goods sold. So revenue is how much revenue or sales is coming in the door. And there may be different components of that with discounts or what have you, there's a gross revenue and a net revenue, but let's say we have revenue, and then there's the cost of goods, so what is the cost to build and deliver the product. And so, this is something that you need to capture as well. And SaaS businesses, this tends to be, cost of goods sold tend to be very, very small, 2, 3, 5% in most cases. If you're building a physical product, like a consumer product good, food or beverage, you'll find that this is a very important cost structure here, because this determines how much money you have leftover to pay for sales, marketing, and other operations, and many investors will look at those margins to see how healthy they are in your business. So you want to be able to capture those and put them in there and understand what's in your COGS, cost of goods sold itself.

After this, after revenue and cost of goods sold, now you come into the section where you put operating and personnel expenses. Operating expenses are basically sales, marketing, product development, administration, etc., and then the personnel expenses are things that are specific to salaries such as benefits, payroll taxes, commissions, and other things like that. And so, these are the things you want to start putting down. And when you do a financial forecast, there's two ways you can approach it. There's the top-down approach, where I just take big broad numbers, and give myself a percent of that, or a bottoms-up approach where I take my current realistic numbers, and actually start to extrapolate on those, and you want to use a bottoms-up approach. Investors will not be convinced with a top-down, and top-down is just used for back-of-the-envelope analysis. Here, people are looking more deeply at this, and so, they're going to want to see a more detailed view into it, and a bottoms-up approach is the way to do it. So you have to go out and look at your current costs, your current revenue, the current average selling price, etc., and from that, start to craft what is the model going to look like each month, and then you start putting your growth rates on it. For the next two years, you do organic growth rate; in the years three, four, and five, you put your operational strategy is coming to fruition, you start to factor that in itself. So these are the things you have to come up with to put into the spreadsheet as well.

Next one is capital expenditure. So if you are buying equipment, or you're buying computers or servers or anything like that, you'll have to have a capital expenditures budget, and you'll have to be putting this into a separate portion to show people, because it's going to be amortized, depreciated over time, and so have a different treatment. And there are certain benefits to having this – this is a hard value in the business itself if you've got that, so it's great to have those as well. If you have any loans or any types of debt financing, you want to put it in this section as well.

So next one is working capital – working capital is capital you need to run the business. And so, basically, it's anything that can convert to cash. So if you take your current assets minus your current liabilities, that's your working capital. And in some cases, this is pretty much your cash runway. And in other cases, it may be things like accounts receivable that you can actually convert into cash as well. And so, you want to look at

any aspect that can convert to cash in the short term, and then calculate that as part of working capital. And this is the magic number that people look at is startup founders do for how much runway do I have before I run out of cash if I'm burning, and most people are burning more than they're bringing it in. So you want to look at this, and inventory, accounts receivable, these are all playing into this number, and you want to calculate what that number looks like, and how it might be going forward.

And next one is, and this is separate from the financials, but we put it here anyway, because this is something that kind of comes up in the same breath with financial projections, and what you'll need to show in a diligence mode to an investor is the cap table, which stands for capitalization table. It basically shows who owns how much of the company in the – it's just a list. And basically, it's their name, and it has the pre-money valuation they bought in at, what it was worth before the investment, post money valuation, what's it worth after the investment, and then a price per share. Oftentimes, cap tables have a percent ownership, you know, this person owns 2%, that person owns 20%, you'll see those listed there as well. But a cap table is part of the diligence product, and often it kind of goes hand in hand with the financials, and so you want to put that in there as well.

[00:08:37] Segment 2 -- What is the Cost of Goods sold?

Hall Martin: So what is cost of goods sold for software? So in SaaS can you have zero value for cost of goods sold. Typically, it's not zero, but it's not far from there. Typically, if you are having to shrink wrap software and deliver it, or, if you have servers that you have to pay for, typically, there's AWS fees or other server fees that you have to pay to host that software, you count those in there. So anything that uses to deliver or build that solution, that's what you have to put into COGS, and in most cases, it's server fees, and if there's any other fees that go along with it, such as sometimes people are mailing things out to be a part of the product itself, you have to count that cost in there as well. Typically, those are usually in the 2, 3, 4% range, it's usually not much more than that, but it's rarely zero because that software has to get from the website out to the user in some manner. And while it's very low cost and scalable, it does exist in that case.

Speaker 2: I asked the original question, and what I had in my mind was that if my software product is delivered over the web as a service, then I'm paying for those servers anyway. That's really a fixed cost, and it's divisible amongst end-users, a number of users that will be changing over time. So what, I guess, I didn't know was how to impute a cost per user in as a cost of goods sold in that scenario.

Hall Martin: Well, if you're paying AWS $10,000 a month, well, then you would list $10,000 as the cost of goods sold for your servers on your financial statement. And if you want to get a per-user rate, well, then you put in, this month, we had 20 users, 10,000 divided by 20 users is that's the rate per user that's going into it. So you can allocate per user on it, but then next month, when you have $10,000 of cost, and you

have 40 users, well, now you're dividing 10,000 divided by 40. So I don't know how you want to use that number. In most cases, people just want to know that that cost is X, and with AWS and these things, you can get into storage costs, and you can get into other things that go with it that add up to more than a trivial amount of money. There's usually some good money that goes into that, and you want to look at that. And that's a question a lot of investors ask is, what's the capacity on your servers, at what point do you run out and have to go to the next price level or to the next level of servers, and there's a jump up in costs. And so, they look very hard at those capacity and cost cases in that case. I don't know if they look at it so much by users, unless you're trying to estimate when you're going to run out of capacity, and then jump up to the next level, but that's what most people are trying to figure out is what is the cost of it. Well, in very early days, it can be expensive to run some of these things, because you're trying too many systems and paying different storage and server fees that go with it. You just have to be able to calculate that.

[00:11:54] Segment 3 -- What is the salary for an entrepreneur for budgeting purposes?

Hall Martin: what is a salary for an entrepreneur who does not pay himself a salary? So in this case, if you want to do actuals, you may not put down a salary for a person, but I recommend putting in a salary just so that you know that this is not – you're trying to build a financial model that at some point, I'm going to have to replace myself with somebody that will want funding. And so, you envision what that person is, okay, once I get this thing built and rolling, I need to hire a $60,000 salesperson to do this work or a $80,000 salesperson, when you start to bake that into the model. So the idea is figure out what it's going to cost to replace, you realize you're building it, so you're at higher costs; but those who are actually going to run it or just transact on it, is usually a much lower cost person. But that's a good idea to go ahead and not just put things down for zero and then call yourself profitable, because you're working for free, and that's not sustainable. You want to put something in there that is sustainable and representative of the business that you intend to build. That's the key is, what are we trying to build, is this going to be run by a $60,000 salesperson or a $150,000 salesperson. And then if there's commissions that go with that, this is the key thing most people forget, realize when sales go up, typically sales commissions go up, most salespeople are commissioned, you have to show those things going up in tandem, no fair sales going up, and then sales expense staying flat. Those two things, sales expense and sales itself, are usually tied together in some format, and so you want to show that in the financials that you know what that relationship is, and if I double sales, well, then sales commissions are going to go up commensurately as well. And that's the value of a financial projection is you know what the interdependencies are, which expenses are fixed, which are variable, and if sales goes up by 2x, what happens to expenses, and that's the real value of financial projection itself.

So, the other thing you need to put in there are taxes, and many startups forget about things such as payroll taxes. Payroll taxes, even if you're not making money, you still have to pay those things. Income taxes, typically, if you're not profitable, you don't have to pay much, but you do need to take that into account, especially when there are months that you are profitable as well. And you can then have to check into what the current tax rates are for you as well, and if there's any local business taxes, some states have some B&O, business and owners taxes that they have to pay on top of the federal tax. So make sure you're aware of the taxes. The one that comes up most is payroll tax, because you have to do that from the get-go. Income tax and those things typically come a little bit later, when you get a little bit further along. If you're filing an S Corp or filing as an S Corp, then you’re passing the taxes through to your personal account, then you're looking at it from that point of view. And then, if you are paying taxes, you want to set up to make quarterly payments into it to avoid the penalties and the fees that come out of it.

So the next thing that you can use with a financial projection is to set valuation. And so, for startups with revenue and projections that you have here, you can then start to calculate what my revenue will be, therefore what will my value be. SaaS valuations today are in the range of 15x revenue. I’ve seen some people try to go to 20, it used to be 10, so we're in a very high valued market for sure. But if you have a recurring revenue business and it's going up, and you're, you know, you can actually put a valuation on that revenue stream by 15x, and that will not look out of place with many of the deals that are out there. If you're very early and you don't have revenue yet, you're just predicting what this is, then we always use the rule of four. We give ourselves a million dollars in valuation for each of four things, the revenue, the team, the product, and the intellectual property. So if each of these things are fully in place and installed today, we have revenue, it's going, give ourselves a million dollars, we have a team, everybody's in place working, give ourselves a million dollars, the product is shipping, it's completely where we want it to be, million dollars, we file patents and been awarded, give ourselves a million dollars. So you come out with about $4 million as what you get as a starting valuation. If you don't have all of those things, you have half a team or half a product, well, then you give yourself, say, $500,000. But this gives you a way of articulating values in the business to the investor, even if revenue is not all the way there, and that's the key is you want to articulate what's in the business today, because investors don't know that, you have to tell them that, and you have to be very specific as to how you arrive at your valuation. And in the end, valuation is a negotiation but it gives you a place to start and gives you talking points that you can use as well for your deal. And once you get revenue and some of these other things rolling, well, then you can start to see how the valuation might be clicking up as the revenue and the team and other factors are clicking up as well.

The next thing you can do with these is to do best case and worst-case scenarios. You can show different things happening here. The ideas in a financial slide, that's okay to do. I don't usually put this in the actual pitch deck, because in a pitch deck, you should

have just the core presentation with one outcome, multiple scenarios in a presentation can be confusing. But in a financial presentation or in the actual handout with the spreadsheet, you can actually put in best and worst-case scenarios. So what you do is you take your standard revenue, and what you have in mind, we'll call that our best case, and then back it off and come up with a worst-case, you know, sales didn't grow as fast, maybe they grew half as fast or a quarter as fast, expenses went up more than we thought. And so, you can do a sensitivity analysis with the worst-case scenario to show how it might come out, given maybe the economy turns in another direction, a competitor comes in and does more than we thought. And so, you can have two scenarios there. I wouldn't go with a third one, that gets to be too much data to go through, best and worst is about as much as most investors can take in. And in both of them, what you're looking at is your cash flow runway, how much cash do we have. And in a worst-case scenario, how many months do we have out there. If the months get too short in a worst-case scenario, well, then it's going to be tough to convince the investor. So there needs to be some cushion in this process as well.

Okay, so if you have any other questions, go ahead and put them in now about valuations or about financial projections. I will say we have a eGuide out there available here for you today. If you go to the TEN Capital website, I put in the chat box the link to it, so you can go out and download that document, and it'll walk you through this process in more detail. And so, what you want to do is get the eGuide that will kind of walk you through step by step how you put everything into financial projections. And if you want, we also have a template, we have a spreadsheet template you can use, just ask for that, ask for the template, and we'll send you that through email, and you can actually go and type it into a spreadsheet where it does a lot of the analysis and calculations for you as well. So let's go back and answer questions. Our valuation's historically high at the moment, and I would say they are at an all-time high, I've never seen them this high before. Even during the dot-com days, it was not nearly as high as it is right now, and that's because it's just a frothy market, interest rates are zero, there's stock markets all-time high. Valuations typically go in concert with the stock market. When the stock market's up, valuations are up. When the stock market's down, valuations are down. And a lot of this keyed off of M&A activity. When companies are being bought at high prices, well, then the valuation is imputed to fundraisers that come before it. So when the stock market's all-time high, you'll find that startups are very high as well. And then some investors know that. They know that it's very high now, and it may not be that high in the future. But right now, it is very frothy in what they are out there. If you do any analysis, you'll see that they're almost double what it was even five years ago, especially for SaaS-based businesses. It used to be a SaaS business was 10x, now it's, in some cases, 20. Some people were trying to apply for 25x, then at some point investors walk away, it's too frothy for them as well.

[00:20:44] Segment 4 -- Salaries for startups

Hall Martin: What salaries are investors happy with. They're usually happy with about 70% of market-rate salaries. So if a standard salary is 120 for an early-stage founder or early-stage employee, they're expecting that to be down by 30%, and the equity compensation they get as far as stock or options should be making up the difference. In the early stage, cash is king, and so, we're not paying full cash, but we're getting what could be valuable equity, and what investors want to see is skin in the game. They don't want to see market-rate salaries ever in the startup; after 10 years, yes, but in the first five to 10, no. They really want to see people being compensated by the equity that they will make by making that a great thing for themselves, it will be a great thing for the investors too. So think about a 30% haircut off the market rate salaries, and what stock equity would take to fill that gap. And then that's pretty much true for the CEO, CTO, CSO, any of the C-level people that are up there. Sometimes for developers, you have to pay a certain rate to get them in the door. Again, I've seen people seeing CEOs offer developers, hey, I'll give you the 150 you want, but here's your stock options of 10,000 shares or if you were to come in at, say, 120, I'll give you 20,000 stock options. So you can start to do some negotiation with the employee to see how much they believe in the company, sometimes they have a financial situation that doesn't let them take it on, but for those who do, you want to make that worth their while with the stock because it can be worth a whole lot more down the way. So it's something to consider as you go forward that typically we don't live in market-rate salaries in the startup plan we're doing things for the equity in most cases.

[00:22:44] Segment 5 -- Difference between Seed and Series A projections?

Yadi: So Hall, for the financial projections, when the investors are looking at it at a seed level versus a series A level, is there a significant difference in how investors care in terms of the financial projections or how much they kind of investigated?

Hall Martin: Yeah, when you go from seed to series A, investors are expecting a higher level of detail, and a higher level of predictability, and the seed, it can be all over the place, and like I say, most of these projections are really about understanding the business. When you get to series A, they start to look, you've had two, three, four, five years in some cases of business operations, you should know more about your business, more about the forecast, more about the customers. Expenses should be very clearly known. You should be managing those expenses very tightly. And so, they're going to – investors are going to expect you to hit those forecasts more accurately at the series A, than you did at the seed. Seed can be all over the place, series A shouldn't be all over the place. And they're going to be expecting you to be able to explain the numbers in more detail. In seed, you have some idea what things cost, by series A you've actually shopped around and found the best price for people and technologies and other things.

And investors will probe further on a series A to see how much more you can save on this, how much more efficient you are, what's the revenue per employee, starts to come into view. And what they'll do with this series A is they'll start to compare you to other companies in your business. At the seed, not so much, because it's all over the place. But the series A, they will start to compare you to other companies, they know other companies that are in your, that are competitive to see why is your cost higher than theirs, why is your revenue per employee lower than theirs. And so, you'll have a little bit more demanding investor, so you'll want to do more research, so you can defend your financials in a more detailed way.

[00:24:46] Segment 6 -- Impact of an SBIR grant on startup valuation

Hall Martin: So next question is: how does an SBIR grant affect the valuation of a pre-seed company – any contract complications for investors? So SBIR grants are non-dilutive grants that come into the business, and what you'll find is that investors are happy to see that, it's extra money, it's non-dilutive, but they don't consider that revenue, and they really don't put too much behind it because it's not like a recurring revenue SaaS where it's going to hit every year, it's a one and done. You get it once and it's over. So they'll give you credit for having that, they'll be appreciative that you've got some money to move the product along and get further down the path, but it really doesn't move the needle much on valuations or anything else. Because, like I say, it's going to happen once, and then pretty much it goes away, there are some groups that go get more grants as well. But what investors really put behind valuation is revenue – revenue is coming in and SBIR is not revenue. There is validation that the government thought enough of this technology to put some money behind it, but you'll find it, it really doesn't impact your valuations. So I would not include it in this case. But I would put it out there to say they thought enough of our technology and our product to put money in us, so that's a validation point, that's worth something, but it's not a valuation metric by any means. It doesn't complicate anything with angels, because the grant just comes in and it's just a grant, there's no ownership that comes with that. So not revenue, but adequate dollars to start us up, that's right. Well, the key with the SBIR grants is to make sure you build product with it. I see many SBIR grants being awarded, and when I go back a year later and see what did they do with a million dollars, they basically said, well, we wrote three white papers. Well, did you build a prototype? Well, no, we didn't do that. Well, that's a missed opportunity. If somebody gives you a million dollars, you build a prototype. I don't care if you're ready, you build a prototype. You don't just write three white papers, and then expect someone else to pay for your prototype, because you'll find angels and VCs are very, very slow to pay for your prototype. They're expecting you to have built that already, and SBIR is an ideal way to build the prototype itself. So get something built with the money. Don't just spend it on salaries and patents and white papers, because that's not going to be a great outcome for you guys. And then if you get a phase two – so phase one is a couple of hundred thousand dollars. Phase two is $700,000. So if you get phase one and two, you have a

million dollars coming in. And like I say, from the get-go, be building product, don't be building white papers for sure, because I see a lot of that out there as well. So that's the story on grants. Like I say, they're typically one and done. I did meet a company once that had spent 11 years working on their technology, and they had raised $4.5 million in grants through multiple agencies and services and so forth. There was just one drawback with that, they did not have a customer, nobody had any sales experience, nobody had any marketing experience, but everybody was an expert grant writer. Well, this is not the business investors want to fund, they don't want to fund expert grant writers, they want to find people that know how to sell, market and build products. So a little bit of grant money is great, but at some point, you have to go over and start building and selling products to customers and exercising that muscle in the business as well.