BASICS OF FINANCIAL MODELING

By Janet Wikler

Direct marketing is bottom-line oriented. Every decision you make has a financial impact; and understanding the financial implications of your business will make you a better direct marketer.

Every good business plan contains a detailed model. This is the financial expression of the operating plan.

The model consists of spreadsheets that build the business from the bottom up. It reflects an understanding of the details that will drive revenues and expenses and expresses the relationships among variables (for example, how staffing assumptions drive salary expenses and how volume and price assumptions drive revenues).

Develop your model early in the business planning process. It will enable you to test and refine your concept by letting you see how various assumptions and scenarios affect results. The model should include the development period and at least five years of operations to demonstrate how the business is likely to evolve over time.

First develop the model on a cash-flow basis. How much cash will it take to develop the product (or each product, if there is more than one) and start operating the business? How long after you launch operations will cash begin to come in? How long will customers typically wait to pay you after placing their orders or receiving their products?

Once you have completed the cash flow model, adapt it to reflect accounting conventions. This is important not only to smooth the hills and valleys of the cash flow picture but also to calculate the impact of taxes in each year.

As you create your financial model, think about which costs are incurred regardless of how much you sell and which are incurred only if and when a unit is sold. In building your model, separate these kinds of costs so you can see how variations in price and volume will affect profitability.

The price received for a unit sold, minus the cost incurred only if a unit is sold, is called the contribution margin. In a business with a high contribution margin most costs are fixed; a relatively high sales volume is needed to break even, but profit rises sharply as volume grows. In a low contribution margin business, it takes less volume to break even, but additional volume contributes less to profit.

The contribution margin percentage may affect the way you manage a business or price a product and will certainly affect your financial expectations.

Whether you are seeking funding from internal corporate sponsors or from outside investors, you will need to forecast cash flows and profits or losses by year for at least five years to demonstrate the potential return on investment.

The return on investment is a function of the yearly cash flows and the value of the business at the end of the plan period. Future cash flows must be discounted by a factor to account for the time value of money. (Money has a "time value" that reflects the income that the cash could have earned in an alternative investment.)

To estimate the final value of the business at the end of the plan period, find out what prices are being paid for the stock of comparable companies in relation to the companies' revenues and earnings. Then apply those multiples to the projected earnings and revenues of your company at the end of the plan period. Take a look at whether the multiples paid for companies in your industry have been changing over time so you can take into consideration the possible effects of price trends.

Outside investors will need an exit strategy that enables them to get back their money plus a return on their investment. Typical exit strategies include a public stock offering or sale of the company to a corporate buyer.

The return your investors expect will be related to how risky they perceive the investment to be. Most people seek high returns on investments in start-up companies because they know that a high percentage of them will fail. Developing a good business plan reduces the risk of failure because it forces you to think through the details of the business and map out a course of action that optimizes the chances of success. Letting investors see that you have planned the business carefully will help them feel comfortable with the risk you are asking them to take.

Janet Wikler is the President of Wikler and Company, Inc., a consulting firm that has helped many organizations strengthen existing operations and develop and launch new businesses. Ms. Wikler has over 25 years of hands-on experience in general management, strategic planning, marketing, finance, and business development, and has served in a senior executive capacity at a number of media companies. She can be reached at janet@wikler.com.

Copyright © Janet Wikler, 2003. All rights reserved.