First Avenue Ventures

The Structured Start-Up

WORKBOOK

MODULE 16: REVENUE FORECASTING

TOPICS COVERED:

Techniques for making a revenue forecast (and pitfalls that founders fall into).

The Structured Start-Up from First Avenue Ventures
https://learn.firstavenueventures.com

LEARN WHAT MATTERS MOST

WHAT'S THE BEST WAY TO FORECAST REVENUE?

"If you can look into the seeds of time, and say which grain will grow and which will not, speak then unto me."

— William Shakespeare, *Macbeth*

"We have two classes of forecasters: Those who don't know — and those who don't know they don't know."

— John Kenneth Galbraith

It may be a dollar short or it may be a dollar high, but it will never be exactly right: forecasting revenue for start-ups is notoriously tough and speculative. You are traveling a new path, and it's difficult to predict exactly where that path will take you.

Forecasting revenue is also the most common source of dread in start-up life. You go out and work for a couple of months; you push hard on sales, but they don't materialize – or, at least, they don't materialize in the manner that you were hoping. While that is possible (and does happen), it's far more likely that you'll fall short of your original forecast.

Nonetheless, imperfect though it may be, it's essential to make a revenue forecast both for your investors and for your team. And there are ways to make your forecast as accurate as possible.

1. **Work forward, not backwards.** In other words, don't take the entire market of widgets and then work backwards, figuring out what percent of the market you can take. That may be useful to show investors the size of the opportunity, but it is a

lousy way to forecast. Instead, start with the number of people currently in your wheelhouse as customers and go forward from there. For example, a new service firm founder may know 100 people who could potentially hire him. If he calls 100, then X% will schedule a face-to-face meeting; then Y% will hire him to do a job that costs, on average, $Z. Extrapolate from the knowns in your market, not the market that you know about through industry trades.

2. **Build out and acknowledge potential impediments to the buyer's journey.** Start with the universe of people who you can reach with your planned advertising and walk through the reasons these people may choose to use your service or purchase your product – and the reasons they may not.

3. **Realize you will be wrong.** The reason banks do not lend to start-ups is that founders don't yet have experience with their customer base. This is the start-up paradox: you don't know what you don't know.

4. **Get the tools that work for you.** Whether it's Microsoft Excel, Google Sheets, dashboards, or paper, it doesn't matter. Data visualization and calculation tools are essential for the business. You should be looking at your data almost daily, so, first and foremost, it needs to work for you.

5. **Don't mistake kindness for sales.** Don't assume that because someone seems to like you personally, they will buy into your company or buy your product/service.

6. **Be brutally honest with yourself.** Poke at everything.

In *Good to Great: Why Some Companies Make the Leap and Others Don't*, Jim Collins writes about the importance of building this kind

of honesty into the organization itself:

"Creating a climate where the truth is heard involves four basic practices:

1. Lead with questions not answers.
2. Engage in dialogue and debate, not coercion;
3. Conduct autopsies without blame.
4. Build red flag mechanisms that turn information into information that cannot be ignored."

In an article for *Inc.*, Les McKeown focuses on being brutally honest as well. His advice is to only include actual income that you're sure of, not estimates of potential income you have from projections. Also, he suggests spending a morning on your projections with your team. Giving your team the time they need to realistically focus on income possibilities makes for better projections. It may be painful for some, but it provides a realistic appraisal of where you are, not a rose-colored perspective of where you hope you are.

In a post on LinkedIn, Zane Tarence, Partner and Managing Director of Founders Advisors Technology Practice, warns against a lack of recurring revenue. This, according to Tarence, can lead to unpredictability when it comes to a company's cash flow. Furthermore, Tarence writes that "Predictable revenue is the number one driver of company value and the indispensable element of investment-grade, scalable companies." In his book *17 Reasons Your Company Is Not Investment Grade & What To Do About It*, Tarence writes about the vital role cash flow plays in "increasing, enhancing, optimizing, scaling, measuring, organizing, planning, and protecting" the value of a company.

In order to make sure that your revenue stream is valuable to your company and to your investors, Tarence suggests performing

a careful audit of the ways in which your company produces revenue. Then, determine which revenue streams can be converted to recurring revenue. Though Tarence urges creativity and discipline when it comes to this exercise, he states that the most reliable ways to create recurring revenue are through contracts and subscriptions. Finally, Tarence offers five reasons why investors look for recurring revenue:

1 - It is predictable.
2 - It decreases a buyer's risk.
3 - It creates value for owners.
4 - It is a launchpad for future growth.
5 - It has a compounding effect on growth rates.

-- Zane Tarence, author of *17 Reasons Your Company Is Not Investment Grade & What To Do About It*

When it comes to revenue forecasts, you are almost always better off being conservative, hitting your numbers, and looking like a winner. However, being too conservative does have its issues. You may not have the resources in place to service the new revenue; raising capital to expand to meet new customers may take longer; and ultimately, you may lose the trust of your stakeholders. "Sandbagging," or providing lower numbers in an attempt to look good, sends a negative message to your investors.

You will not be perfect, but you should try to be as accurate as possible. When you miss -- high or low -- you need to figure out which of your assumptions was incorrect and fix it. Making the wrong assumption but transparently correcting the mistake is the sign of good leader. Being overly conservative in an effort to look good later is fool's gold.

CONFLICTING DYNAMIC

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QUESTIONS TO CONSIDER

1. Which data visualization and calculation tools work best for you?

2. What are the potential impediments to the buyer's journey?

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QUESTIONS TO CONSIDER

3. What actual income are you absolutely sure of?

4. Which revenue streams could be converted to recurring revenue?