First Avenue Ventures

The Structured Start-Up

WORKBOOK

MODULE 17: UNIT ECONOMICS

TOPICS COVERED:

How to perform a unit economic analysis, including a discussion of recurring revenue and scale.

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

LEARN WHAT MATTERS MOST

WHAT LEVEL OF SCALE MAKES THE MOST SENSE FOR YOUR BUSINESS?

“It’s not what you earn, it’s what you spend.”

— Paul Clitheroe

Ultimately, every organization – even a non-profit – needs to reach a level of sustainability that makes it work from a financial perspective. If you’ve hit and found your market, reaching that level of sustainability is much easier.

Unit economics are fundamentally important for growing businesses. You have to sell something that costs less to make than it does to sell. This applies to non-profits as well, if you take the view that they need to sell their cause to their donors. But unit economics also involves looking at the transaction at a more fundamental level: does it really cost less to make than sell? There are a thousand different ways to put a perspective or a spin on that, but at some point, a business has to make a profit.

To think about your unit economics, start with revenue and realize that not all revenue is created equally. For example, there’s a substantial difference between recurring and non-recurring revenue, as shown by these definitions from Baremetrics’ Business Academy:

“Recurring revenue is the backbone of SaaS and subscription-based companies. At these companies, customers purchase a service on a consistent basis, giving the company the ability to project future

revenue more accurately. Recurring revenue can be calculated with metrics like churn rate and user growth rate for a realistic view of the company's future income. This type of predictability is very valuable in business.

Non-recurring revenue is made up of one-off payments that may or may not happen again. For instance, assume a SaaS company launches an event and gets 50 people to buy tickets. The revenue from this event is non-recurring because it's hard to assume that attendees will return next year (if there is a next year). It's much more likely they'll continue paying for SaaS that's integrated into their business."

Recurring revenue has its obvious advantages. If you know how much cash you'll earn from your customers, financial planning is much easier, assuming you don't spend more than you take in (and if you do, you have a different problem). But the search for recurring revenue should not be all-consuming. While a revenue model based on recurring revenue may be preferable, there are other valid revenue models.

The other side of the revenue model equation is cost structure. In that analysis, you need to be realistic and account for all the inputs necessary. A key factor is determining which of the organization's costs are fixed as opposed to variable. It's also important to consider one-time costs versus ongoing costs.

The other factor in this is scale, a term often cited as a barrier to growth but rarely fully understood. Simply put, certain businesses work at one size level and not at others. Facebook, for example, needed a massive number of people on the network before the unit economics worked through the sale of advertisements on their feed. While that level of scale is obviously enormously successful for them, the path to that success was fraught with risk (just look at the Friendsters and Myspaces that were left along the way).

Sometimes the unit economic analysis will focus on four-wall profitability (for retail) or per-customer economics. These are useful and necessary ideas, but you also need to take a step back and see at what scale your organization makes sense.

Sometimes the answer is a small scale. A mom-and-pop store may work as a mom-and-pop, but at a larger scale, the business may not work. What is the fixed cost necessary to make that small business work? And does that fixed cost make sense for that business?

Sometimes the answer is very large: you have to have huge scale in order to make the economics work. And with that, a realistic assessment of what is necessary to get to that large scale comes into play.

If something's easy, everyone will do it. Entrepreneurial risk involves finding something that the market has yet to figure out, so in any new market, unit economics are tough. You don't know what you don't know. However, figuring it out is key.

CONFLICTING DYNAMIC

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QUESTIONS TO CONSIDER

1. What, if any, are your sources of recurring revenue?

2. What, if any, are your sources of non-recurring revenue?

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QUESTIONS TO CONSIDER

3. Which of your organization's costs are fixed? Which are variable?

4. What level of scale makes the most sense for your business and your product?