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# Preparing Financial Projections

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This article is about developing realistic financial projections to quantify the company's business model.

Main Points in this article:

- 1 Financial projections flow from the strategic options outlined in the business plan.**
- 2 Financial projections need to show when the company will achieve its breakeven point.**
- 3 Financial Statements need to highlight the cashflow implications of the sales cycle.**
- 4 Industry attractiveness is critical and influences the supply of capital.**
- 5 Industry structure may lead to significant opportunities or major changes that may put many companies out of business.**

By Peter T Gow

Financial projections endeavour to quantify the strategies outlined in the business plan.

Business plans usually include "best guess" or sometimes, "optimistic" numbers. For early stage companies, it is hard to predict penetration rates for new products or even the adoption rates for new markets.

Depending on the stage of a company's development, these projections can be "conservative" or just mere "fantasy".

It may be very difficult, especially for early stage companies, to predict the likely revenues and future profits. Sometimes, there are just too many unknowns.

Unknowns create higher risk for seed or start-up investments where the technology or the product is yet to be tested fully with the customer.

The real aim of financial projections is to provide some insight into when a company will achieve breakeven sales, or for the next stage, achieve acceptable margins.

Knowing when the net cash flows turn positive, or when margins exceed certain levels, is very important and will determine the future viability of the business. It will also impact the ability of the company to raise capital.

Financial projections reflect the underlying strategic opportunities.

## Business Plan

The Business Plan needs to clearly outline the value proposition, and explain why the product or service offering is unique. This uniqueness or competitive differentiation will drive sustainable performance.

The plan needs to include a detailed market analysis which identifies the size (revenues and volume) and features of the market.

Market structure and market growth needs to be fully understood and presented in the projections.

The two key questions are:

- Is the market size greater than \$100 million and are the growth rates in the industry greater than 15%?
- Is the industry structurally attractive with significant barriers to entry?

The first question will highlight the position in the cycle, whether the market is growing, reaching maturity or declining.

Growth markets are generally far more attractive for investors, because it is easier to gain market share in a growing market than fight for share in a mature or declining market.

Industry attractiveness is critical.

Michael Porter focuses on the collective effect of five forces:

- ❑ Threat of new entrants,
- ❑ Threat of substitutes,
- ❑ Rivalry among existing firms,
- ❑ Bargaining power of suppliers and
- ❑ Bargaining power of buyers/customers.

Porter is the author of many books on competition and strategy, including “*Competitive Advantage: Creating and Sustaining Superior Performance*” and “*Competitive Strategy: Techniques for Analysing Industries and Competitors*”.

Industry structure may lead to significant opportunities or major changes that affect many companies.

It is therefore important to consider the overall industry projections and the impact of competition.

- ❑ Are the industry growth rates sustainable?
- ❑ Are current entry barriers sufficient to discourage new entrants?

The answers to these questions will have a major impact on your financial projections.

### Income Statement

The breakeven calculation is critical for determining the level of sales required for covering the underlying fixed costs.

It is calculated by dividing your fixed costs by your gross profit margin.

The sales figure is based on the expected price, multiplied by the number of units to be sold.

Pricing is a critical consideration

and will determine the level of the margin. Investors are generally not interested low margin businesses.

The margin also reflects the costs of production and marketing. The real questions to ask:

- ❑ Do the margin forecasts make sense?
- ❑ Are they consistent with the Business Plan?
- ❑ How do they compare to competitor or industry margins?

Costs will be dependent on the bargaining power of suppliers and/ or customers, and scale.

### Balance Sheet

In order to generate the targeted sales, it is necessary to take into account the level of investment required.

- ❑ What level of investment is required to buy raw materials, labour and other overheads, and to convert these resources into finished product?
- ❑ How long will the finished product remain in stock before a sale occurs?
- ❑ How long does it take for the customer to pay for these products?
- ❑ When does the company have to pay its suppliers?

The above questions reflect the working capital cycle of the business and how long it takes to fund the sales cycle.

Generating sales may require significant working capital or a major investment in capital equipment.

It is important to understand the cash flow implications of the sales cycle and the payback periods for any new investment.

- ❑ Will the proposed investment have a payback period of less than 18 months?

The projected financial statements also need to present any key performance indicators of the business. Indicators like sales growth per annum, sales per employee, profit percentages, or working capital ratios need to be considered.

### Sensitivity Analysis

The financial projections need to show how the company intends to grow revenues and achieve profitability under different scenarios.

- ❑ How will the company expand its products or customers?

The projections need to be compared with the industry projections.

- ❑ Do they make sense?
- ❑ Will the company actually increase sales from \$10 million to \$40 million over the next 5 years and maintain its margins?
- ❑ How do these projections compare with the industry projections?
- ❑ Where is the industry cycle?

The projections need to be subjected to sensitivity analysis: the most likely outcome, the most optimistic and the most pessimistic outcome. These scenarios need to consider unique events that may impact the company.

Things to consider include price movements (up as well as down), supplier or customer influences, resource constraints, or the impact of new regulations.

These scenarios will assist in determining your capital requirements, or valuing your

business. Check this Website for further articles on **Determining your Capital Requirements and Valuing your Business.**

Financial projections flow from the strategic options presented in the business plan. However these projections are heavily influenced by the underlying assumptions.

Assumptions may reflect competitive pressures, economic factors, and the cost and effectiveness of internal processes.

The assumptions that feed into the financial projections need to be realistic. If the company is unable to clearly demonstrate the viability or sustainability of the underlying business, raising capital for future growth will be an extremely difficult task.

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