

What Is a Startup Financial Model? And How to Build One

CapitalPilot

A startup's financial model is a crucial tool for funding success. It's important to show potential investors that you, as a founder, understand the key revenue and cost drivers for your business when you're looking for early-stage funding.

One of the most significant headaches founders experience when preparing to fundraise is the subject of financial models. Let's talk about what should be in your model and, more importantly, why you need one.

Your startup's financial model shows potential investors what they want to see. And, while it can be onerous, the process of building a financial model actually benefits teams as it forces you to think clearly about your assumptions, pricing models, growth rates and risk factors. In addition, financial modelling shows investors that you are targeting a large enough market. Creating an economic model is also an intelligent way to plan the amount of funding you require.

Why does my startup need a financial model?

You may be thinking, "I don't see the point of spending all that time putting together a financial model. It's just guesswork; reality will be completely different."

We hear this from founders all the time, and we get it. But, telling your startup's story is critical for the success of any company or startup, and your financial model is an extension of your story. A considered and accurate model shows what is achievable, and what can be expected from your business. It paints a picture of the size of the market you seek to address, and illustrates your ambition to potential investors. A solid financial model is also a litmus test for your assumptions—are they realistic?

The good news is that your model does not have to be 100% correct. Mark Suster of Upfront Ventures (LA-based venture capital firms) makes this point in his excellent blog:

"See [I don't care if your projections prove wrong over time](#). I care about your assumptions going in. I care about the thought that you've given to the customer problem. I care about how much you've thought about market share, competitors, adoption rates, etc."

How to build a financial model for a startup?

There are many templates available online. But, if you're not an Excel or Google Sheets wizard, they can be a little confusing. A word of warning: while there is some excellent

advice available online, you'll also find plenty of inconsistent, and in some cases, incoherent direction too.

The team at Capital Pilot have reviewed hundreds of financial models and spoken to dozens of investors. Here are our top eight tips for financial modelling success:

1. **Be sure your financial model shows monthly data for at least three to five years.**
2. **Focus on cash flows.** If you have a Profit & Loss statement and Balance Sheet, include those as well, but for seed stage companies cash is king.
3. **Provide detail on your cash inflows and costs and expenses.** This shows potential investors how you believe revenues and costs will evolve and the key drivers and risk factors.
4. **Make it understandable.** We see too many models that are glorified internal documents. While you may know what 'Salary, Claire' means, investors won't.
5. **Use formulae, not hard values.** Including formulas in your model is akin to 'showing your work' in maths class. Helping potential investors understand the logic for each value in your model allows them to understand and assess the logic behind your projections.
6. **Get a second opinion.** Have your financial model reviewed by someone with experience. Ask them to identify any errors, of course, but also whether the model is easy to understand.
7. **Be consistent.** Ensure the information in your model and pitch deck are consistent. Same numbers; same category titles; same everything.
8. **Say it again and again.** Don't include big picture items in your model that aren't explained in your pitch deck. For example - the Capital Pilot team often sees a new revenue source in a financial model that isn't covered in the related pitch deck. Ensure your ideas and explanations are consistent across your materials so potential investors are clear on your vision, value and growth potential.

Building revenue

Your startup's revenue is a crucial factor in a potential investor's investment decision so your model must clearly demonstrate key revenue drivers. Be sure to include:

- All the sources of revenue for your business.
- Information on your revenue model(s) such as subscription fees vs consulting.
- Detailed revenues for each relevant client/customer or revenue type, with the appropriate drivers for the calculation, for example: Number of clients, % increase

in number of clients, Revenue per client, % increase in revenue per client or Total revenue.

Cost and Expenses

Your model should break down all critical cost items and, where necessary, and explain its link to the revenue line. This is key for variable costs of production and for any expenditure that affects revenue, such as marketing.

Your logic should continue throughout the whole of the model.

- **Wages:** Personnel expense is the most significant item for most early stage businesses. Make it granular; each significant position, salary, salary growth rates, other compensation.
- **Marketing:** Some businesses are driven by marketing - marketing spend may be the key driver to revenue growth, with Customer Acquisition Cost being an industry-standard or observed value, and revenues being a function of CAC and marketing spend. If so, ensure that this is clearly explained.
- **Include everything:** Make sure all relevant costs are included. Tax often gets forgotten. You may be lucky enough to have to pay it one day, and it makes a significant difference to cash flows.

It's worth noting that many models maintain costs which are below market-rate throughout the lifetime of the model, such as a CEO salary of £3k per month when the business is generating annual revenues of £25 million or office-rent at £500 per month for the full 5 years. Many companies pay less than market rate for many services in the early years, but make sure your model includes market rate costs by the end of the forecasting period.

Cash

Ultimately, the startup financial model is all about cash. So make sure that the financial statements resolve to a cash line. It is important to know that your business has enough money to keep going. At the very minimum, show:

- Beginning cash. Your bank balance at the beginning of the period.
- Net cash flow. How your cash changed across the period.
- Ending cash. Your bank balance at the end of the period.

All sources of cash should be included here - investment, including expected future rounds, grants, tax credits and so on.

What is an investor looking for?

A financial model isn't just an exercise in futility; there's a point to it. Several points in fact. A potential investor wants to see:

- that you have a good handle on the revenue drivers of your business;
- the evolution of your costs and expenses over time as compared to revenue growth rates to ensure that your business model profitable and scalable;
- if you are realistic about growth potential;
- that your financials are complete and presented clearly; and, finally,
- how their investment will be used and whether more will be needed in the future (it probably will).

Return on investment

The single most important thing a potential investor wants to know is whether your startup's financial model demonstrates the ability to achieve a 10x return on investment.

Yes, it's a bit of a game. Founders build models to demonstrate the outcome they know investors are after, but it must be realistic, cohesive and complete to demonstrate 10x return potential. Remember, your financial model is a display of your ambition as a founder, and an important show of understanding the requirements of your audience.

Most importantly, your financial model is a test of understanding, method, and credibility, making it ultimately as important as your pitch deck.