U.S. Small Business Administration

Boots to Business Module 4

The Economics of Small Business Start-up

Version 4.0

Objective

Understand the relationships between revenues, costs, price, and sales volume to predict the profit potential and sustainability for your planned venture.

Agenda

- Economic Model of a Business
- Revenues
- Volumes
- Margins
- Operating Leverage
- Implications for Risk

Business vs Economic Model

Business Model

How the business ***creates and delivers value*** to the customer

Economic Model

How the business ***captures that value*** in the form of an economic return

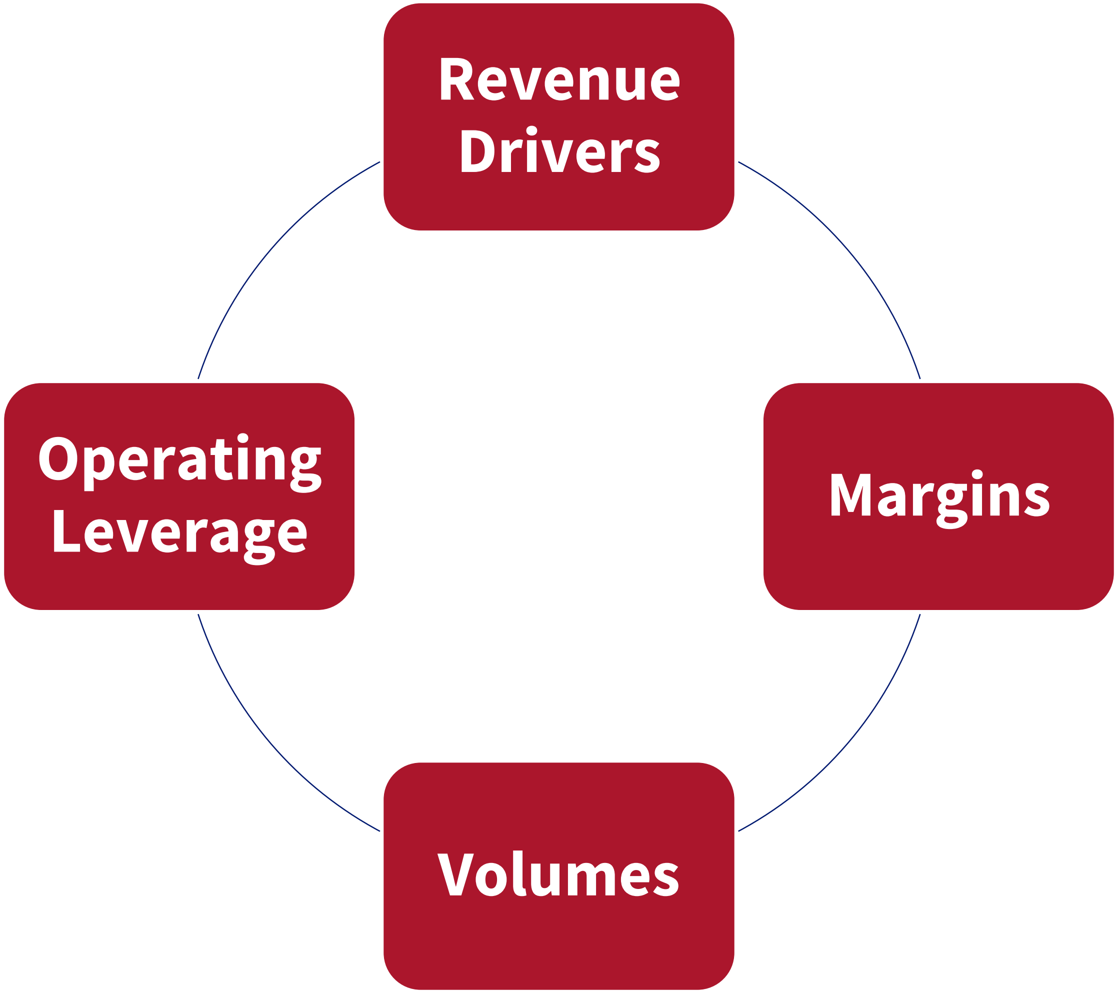
Why This is Important

Benefits of understanding your economic model

- Helps build a sustainable competitive advantage
- Informs your management decisions
- Provides stability and consistency

Are we *making* money or *moving* money?

Economic Model of a Business



Example in Practice

Business Model

Economic Model

Revenue Drivers

How many ways does your company have to earn money?

- One source or several?
- Implications for risk?
- Is this a competitive advantage OR a disadvantage?

Talking About REVENUE DRIVERS

How are their economic models different?
How many revenue drivers do they have?

Margins

The Difference between *Price and Cost*

- What *price* do you charge for your product or service?
- How much does it *cost* you to deliver that single unit of product or service?
- Does the <u>difference between the price you charge</u> and <u>the cost of production/sales</u> provide adequate cash to cover fixed operating expenses and generate a profit?

Talking About MARGINS

Porsche Panamera -- $90K

Nissan Versa -- $15K

How are their economic models different?
Which one has the higher margin?

Volume

The number of units of product or service you are selling or providing

- Is generally meaningless unless you discuss it along with margin
- High volume alone is meaningless unless you keep something from each sale = margin

Talking About VOLUME

How are their economic models different?
What role does volume play?

Operating Leverage

Operating Leverage **is the relationship between** ***variable costs*** **and** ***fixed costs***

- Higher fixed cost model = high operating leverage
- Higher variable cost model = low operating leverage

What is the difference between *variable* and *fixed costs*?

Fixed Costs

Expenses you have to pay no matter what sales you generate

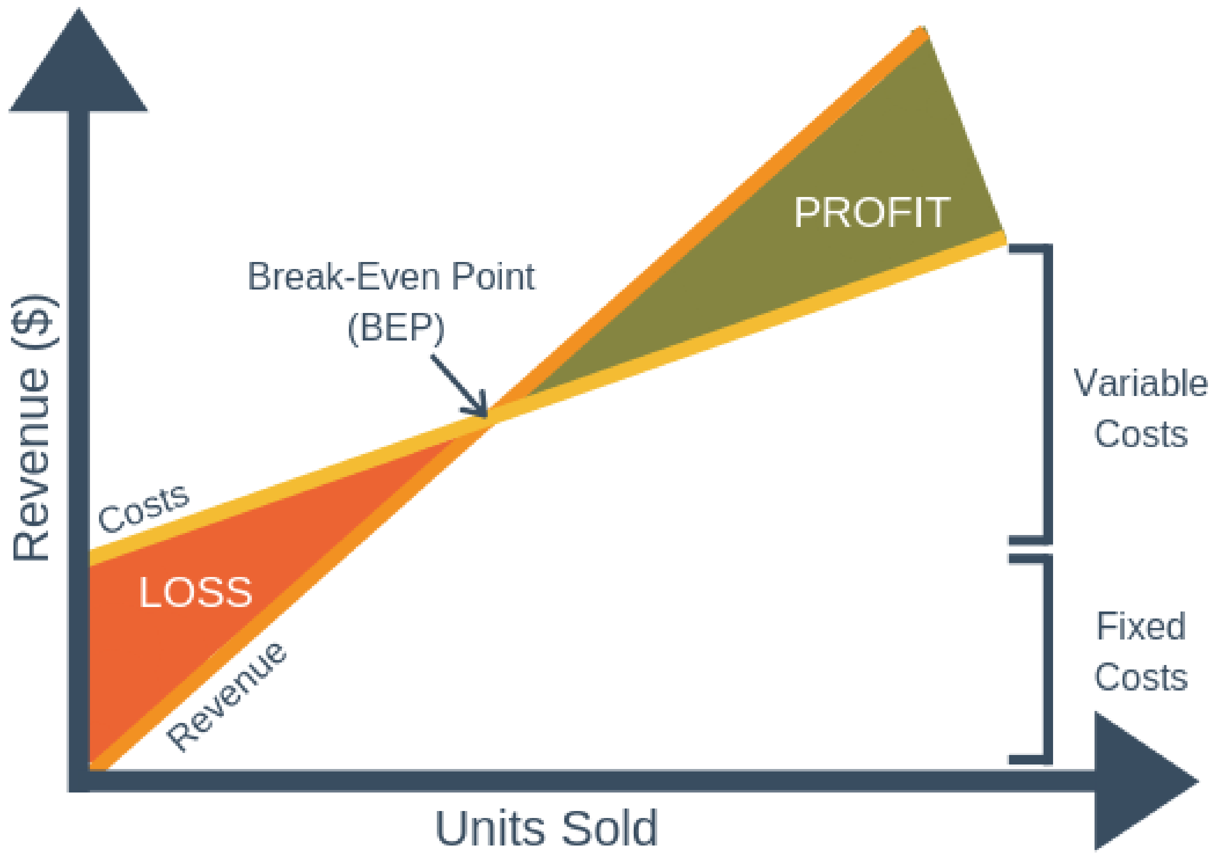
- Remain the same over a given period of time
- Includes rent or mortgages on brick and mortar location and equipment; salaries (not hourly pay), advertising, insurance, consulting contracts
- What about utility bills? Variable or fixed?

Variable Costs

What does it actually cost to deliver one unit of whatever you do?

- Change in direct relation to your revenue
- Raw materials; direct labor, including payroll taxes and costs per employee (CPEs); packaging; mileage, unit transport or delivery; sales commissions
- *Variable* does not mean *optional*

Breakeven



Definition: The volume of sales revenue needed to cover all of your costs over a given period of time.

Adjusting the levers of economic model affects the bottom line

Giddy Up Coffee

Sales		
Price per cup	$2.00	
Sales volume per month (units)	3,200	
Total Sales		$6,400
Variable Costs		
Food Costs	$0.50	
Cup	$0.05	
Other supplies	$0.10	
Variable costs per unit	$0.65	
Total Variable Costs		$2,080
Per Cup Margin	$1.35	
Gross Margin		$4,320.00
Fixed Costs Each Month		
Rental Space	$1,200.00	
Cart Lease Payment	$750.00	
Transportation & Utilities	$625.00	
Insurance	$450.00	
Other fixed costs	$1,295.00	
Total Fixed Costs per period		$4,320.00
Net Profit		0.00

Increased Sales Volume

Giddy Up Coffee

Sales		
Price per cup	$2.00	
Sales volume per month (units)	4,000	
Total Sales		$8,000
Variable Costs		
Food Costs	$0.50	
Cup	$0.05	
Other supplies	$0.10	
Variable costs per unit	$0.65	
Total Variable Costs		$2,600
Per Cup Margin	$1.35	
Gross Margin		$5,400.00
Fixed Costs Each Month		
Rental Space	$1,200.00	
Cart Lease Payment	$750.00	
Transportation & Utilities	$625.00	
Insurance	$450.00	
Other fixed costs	$1,295.00	
Total Fixed Costs per period		$4,320.00
Net Profit		$1,080.00

Improved Sales Margins

Giddy Up Coffee

Sales		
Price per cup	$2.25	
Sales volume per month (units)	4,000	
Total Sales		$9,000
Variable Costs		
Food Costs	$0.48	
Cup	$0.04	
Other supplies	$0.08	
Variable costs per unit	$0.60	
Total Variable Costs		$2,400
Per Cup Margin	$1.65	
Gross Margin		$6,600.00
Fixed Costs Each Month		
Rental Space	$1,200.00	
Cart Lease Payment	$750.00	
Transportation & Utilities	$625.00	
Insurance	$450.00	
Other fixed costs	$1,295.00	
Total Fixed Costs per period		$4,320.00
Net Profit		$2,280.00

Operating Leverage: High vs Low

HIGH FIXED COSTS = HIGHER OPERATING LEVERAGE

This means:

- More money out of pocket every month, regardless of sales revenues
- Higher margins required
- It takes more units of service each month to break even
- Greater risk

LOW FIXED COSTS = LOWER OPERATING LEVERAGE

This means:

- Operating expenses are more directly tied to sales
- It takes less units of a service each month to break even
- Less risk
- Less money out of pocket every month

Before you open your doors, ask yourself:

1. How will I generate sales dollars/revenue?
2. What are my total sales-related/variable costs to do that?
3. What are my fixed operating costs to run my business for a given period of time?
4. How much sales revenue must I generate to cover ALL my costs, so I begin to show a net profit?
5. Based on my research and analysis, can I generate the needed sales dollars and manage these expenses to actually have a sustainable and profitable business?

Key Takeaways
Understanding Your Economic Model

REVENUE DRIVERS: How many ways do you have to generate sales revenue? Does the number of revenue drivers increase or decrease your risk?

MARGINS: What is left over after each unit of sale to pay fixed costs? What percentage of sales is that? When do you break even?

VOLUMES: How many units do you sell each period? Is it enough to exceed breakeven? Is there enough sales volume to make your business profitable and worthwhile?

OPERATING LEVERAGE: New businesses will need to maintain a low operating leverage (high variable cost) model to manage risk and maintain liquidity.

Questions
&
Discussion