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Business Model Risk

What is business model risk?

Experts define business model risk as "all risks within the business model [that] can endanger the profitability and sustainability of the business model or even company goals and value". For our purposes, business model risk pertains to the *financial viability* of the business and the prospects for *profitability* in the near-term.

Most startups struggle to become profitable in their first two years of operations, and end up going bankrupt before their business model can be proven and before they get enough traction to raise funding. Some businesses feature a more advantageous balance of cost and revenue streams, and are therefore better positioned to reach profitability while they still have runway from bootstrapping or seed funding. In contrast, others are more difficult to make profitable since margins are thinner or fixed costs are greater, and therefore face greater business model risk.

Even when business models are difficult, strong customer acquisition and month-on-month growth are good signals that the startup is on the right path and are, therefore, compelling data points for investors. In fact, investors are likely to be more impressed with hockey stick growth (rapid customer acquisition) than profitability in the early days. Some investors go as far as to say that growth matters more than profitability, especially if that growth can deliver access to low-cost venture capital. While some subscribe to this perspective, others qualify this approach noting that "this strategy may only benefit companies seeking to surpass the $100 million threshold in the short term". And other investors outright criticize this way of thinking, asserting that a "growth at all costs" model is flawed in the long run, especially in emerging markets.

In all, startups need to set growth objectives that fit their business model. For example, B2B companies may want to focus on fewer, bigger clients while others may find that rapid customer acquisition makes sense. No matter the approach, consistent usage rates as well as strong customer retention, consistent month on month revenue growth, and high customer lifetime value are important metrics to track for any startup seeking to validate their business model.

In addition, startups in emerging markets need to integrate the reality of operating in a tougher business environment into their model assumptions, such as a lack of infrastructure, limited connectivity, higher cost of data, the need to reach customers with a human touch. As Cochran says, "integrating this reality into positive unit economics is a critical step to long-term value – maybe not right away, but eventually".

As such, our suggestion for managing overall business model risk is to consider the balance of costs and revenue early on, keep a close eye to the most important metrics for the business, focus on retention and not just acquisition and strive for positive unit economics from the get go. To keep track of it all, we suggest startups invest in dashboards and other processes for facilitating analysis.

Key factors of business model risk

- Scale needed for profitability
- Current number of customers
- Month-on-month customer growth rate
- Churn rate
- Retention rate
- Months in operation
- Months of runway - cash on hand
- Monthly revenue
- Month-on-month revenue growth
- Recurring costs
- Fixed costs
- Variability of input costs
- Unit economics: CAC, LTV

Mitigation strategies

Develop a robust financial model, and reference it often

A helpful tool to address business model risk is to construct a robust financial model for your business, to thoroughly understand your cost and revenue levers, and to forecast your key metrics over time. The good news is there are many resources out there that can help you build a sound financial model. A quick search for "financial model template" produces dozens, if not hundreds, of Excel templates that you can use to start plugging in your fixed and variable costs, as well as expectations around customer acquisition and retention (see below for some suggestions). Of course, it's essential to plug in numbers based on valid assumptions depending on your product vertical, customer segment and market.

A financial model is not a magic bullet, but rather a way of naming and quantifying the factors or drivers that will determine the success of your business, thereby revealing which ones are the most important to your business' survival. The trick is to add enough detail to create sufficient accuracy, while preserving enough simplicity to keep the model usable and to reveal underlying relationships and dependencies between metrics. It is also important to allow for ranges of estimates, not just specific points. Many times, the model will reveal how sensitive your business is to something like customer acquisition costs, so pay careful attention to those numbers (this article might help).

Test assumptions frequently to inform your growth strategy

If your company is facing business model risks, a good financial model will also allow you to generate and test assumptions regarding the levers that may be impacting your growth and success, as well as to quantify your margin of error, given unknowable fluctuations, market shifts, and resource limitations. For example, a financial model can help you determine the impact of variation in key inputs -- like greater churn, the cost of a new hire, or an increase in input prices -- on your bottom line.

A model can also tell you what you need to grow, and when economies of scale may kick in. With these in hand, you can then plan targets and milestones for each quarter, thereby enabling your team to “live the model”.

Create a core set of dashboards to embrace data-driven decision making

Once you get the hang of modeling, you will develop a sense for the key metrics in your business model. These metrics should be integrated into a core set of dashboards, including a financial dashboard along with your customer retention dashboard that you track with consistency. Seeing these metrics evolve over time will allow you to make data-informed business decisions and pinpoint the correct strategy for adjusting your model. For example, if costs are growing faster than revenue, then you need to reevaluate the marginal cost structure of your model. Embracing a data-driven approach to business will allow you to stay agile, refine your product offering, get clear market validation, adjust your model as you go, and be more resilient to unavoidable shocks.

Additional resources

- Financial Modeling for Startups
- How to understand the financial levers in your business
- Long list of helpful articles and templates
- Startup financial model template
- Another startup financial model template
- SaaS financial modeling template
- EY Finance Navigator software
- EY Guide to financial modeling for startups (includes definitions for the types of data to include in a financial model)
- Step by step guide to create a bullet-proof financial model