THE CFO BOARD

LETTER FROM CFO'S DESK

Growth vs Profits: Walking on a thin line

Welcome to the first edition of our "Letter from the CFO" series. These letters will capture the CFO's perspectives on current issues that are garnering attention from founders, investors and other stakeholders.

The first letter in this series is to the founders, capturing the key aspects to be considered while implementing strategic decisions involving prioritization of profit over growth in today's economic environment. Given the prevailing discussions on a funding winter, it nudges founders to focus on stronger unit economics along with softer aspects, such as governance and employee wellbeing, balancing the growth prospects and paving a reasonable path towards profitability.

Decoding the funding winter- The startup ecosystem is in the midst of a funding winter. Leading investors have issued letters to their investee companies, highlighting the need to conserve cash and focus on the bottom-line as they have applied brakes on fresh rounds of funding. The uncertainty in the global economy due to high inflation rates, the Fed's interest rate hikes and impending whispers of a recession combined with the current global geopolitical situation with the ongoing Russia Ukraine War and increasing tensions with China are all accentuating the funding winter. Even the number of IPOs launched in India and globally have seen a significant drop in the last six months as compared to the previous year.

Cash conservation- This sudden change in market dynamics has made cash conservation as one of the most important focus areas for startups. Gone are the days of cash burn in the name of Customer Acquisition Cost (CAC) and the pursuit of hypergrowth. Large investors have voiced the same publicly and have advised founders to rationalize the spends.

Shifting towards profitability- While cost rationalization is fundamental to all business, generating free cash and profits was not seen as a key focus area in startups. Because of the ongoing funding winter, the financial/Balance Sheet discipline, which has always been visible in most legacy businesses, is now receiving more attention at startups. Investors, have now started focusing on key financial metrics, apart from growth metrics, while making investment decisions. It is now important to showcase a clear and achievable path towards profitability. Even from a regulatory perspective, SEBI is constantly coming up with recommendations for stricter norms for startup listing to ensure that investors have more skin in the game and are more confident before investing in new age companies.

As CFOs, a key part of the remit is to drive efficiency and fiscal discipline. Financial and operational efficiency work in tandem. A clear business model and well thought-out strategy lead to cost optimization and increased profits, thus, creating value for all stakeholders and potentially attracting future investments at improved valuations.

Growth & profit- The most important point that the company needs to realize in a startup phase is that profitability can not be disregarded indefinitely in the interest of valuation or hypergrowth. Every startup needs to work towards profitable growth through a long-term commitment to serve customers, meticulous planning, and operational & financial efficiency. The company needs to have a robust and agile business model, which can stay afloat in a downturn or a crisis like Covid, but which can accelerate its growth and profitability when the economy is booming. If a business makes good profits, it ultimately lifts the valuations and improves the ability of the company to raise capital. It is this characteristic of a sustainable profitability which will ultimately decide the longevity and the growth of the business.

Hypergrowth will still be relevant- It is important to know when to shut down a bleeding business. Due to the technological disruptions in the last few years, the expected time-period for a business to scale and attain profitability has crunched. Whereas a conventional business used to take, say, a decade to reach a level of stability in operations, a startup is expected to do it in a much shorter period of say 3 to 4 years. But there is a thin line between spending money and burning cash for hypergrowth. Proper cost-benefit analysis (additional cost v/s additional revenue over the lifetime) needs to be done before investing the money on growth. The long-term financial growth model-a sustainable revenue CAGR and steady

state net margins-is essential to devise, execute and communicate.

Measurement is key- If you can't measure, you can't control. While running a profitable startup, a thorough understanding of each component of the P&L statement of the business is crucial. The role of Financial Planning and Analysis (FP&A) teams cannot be overlooked in this regard. There needs to be a clear distinction between fixed and variable costs. The company needs to check if it is generating enough cash to pay these costs. Optimizing costs ensures economies of scale, operational efficiency, and better profitability.

Not only financial performance indicators, but operational performance indicators also play a major role in monitoring growth and achieving profitability. These operational performance indicators need to be captured in MIS reports and used effectively to monitor the business growth. Only when these indicators are captured, analyzed, and used for better decision making, will the company be able to control its cost structure. Finance and IT team should work alongside the leadership team to develop automated and customized MIS reports capturing the relevant KPIs. The technology should be used as a lever to support the overall mission of the company moving forward.

Managing stakeholder expectations- Another key factor which needs to be highlighted is stakeholder management. Customers may not want to pay the desired amount for the product. Investors may have planned their exit in mind. Employees may want higher salaries. The Government may want to charge higher taxes. However, as the founders of the company, it is imperative to invest time in understanding stakeholder expectations and clearly communicating with them to get alignment on the vision and long-term strategy.

Focusing on corporate governance- The founders and senior management need to make sure that the practices and processes followed by the company are ethical and transparent. This principle should be embedded in all the operations of the company from the first day itself. Businesses operate in a rapidly-changing environment and the rate of change is even faster for a startup. To survive in such a dynamic scenario, it is necessary to have a mechanism in place to evaluate the potential risks that can impact the functioning of the business and take necessary steps to mitigate. The risk management framework needs to be focused on business-critical risks and opportunities and should be kept current as the risk environment changes. This will not only help navigate through tough business scenarios but also provide with future growth opportunities. Building a culture of compliance at all levels in the organization with demonstrated zero tolerance with lapses is important from day 1.

Talent scarcity is a risk that can derail growth and profitability- Hiring and retaining the right talent across the organization is a critical factor to help translate the company's vision into reality. Building a strong culture driven by a focus on ethics and governance will also aid in attracting and retaining talent, which, in turn, provides investors and other stakeholders with greater confidence in the organization.

Summary

As companies navigate through the current turbulence in the markets, it is important to strike a balance between growth and profitability as the two are not mutually exclusive or conflicting. This is also a time to revisit the foundational building blocks for businesses to emerge stronger.

Hypergrowth must be driven by a razor-sharp focus on financial viability and the path to stakeholder returns. At the same time, focusing on the foundational aspects of governance, stakeholder management and talent will equip the organization to achieve its objectives of growth and profitability.

1. Indian startup companies should shift gears towards achieving optimal profitability metrics and cash flows in addition to growth to substantiate their valuation. It is imperative for startups to focus on positive gross margins to be sustainable. This should be enabled by regular tracking of key metrics.
2. As a founder, it is of utmost importance to understand when to pivot or shutdown a bleeding initiative or business. For example, if a company has been continuously going through poor operational performance, low sales or a weak strategy, it might be the right strategy to exit the business rather than burning cash.
3. It is imperative that founders effectively identify different stakeholders, analyze their requirements and develop strategies for establishing strong relationships. Keeping them engaged and informed about how businesses are navigating the current challenges will allow for meaningful dialogue and counsel.
4. Adding to the above, the focus should be on building good corporate governance practices and ensuring compliance with statutory regulations as it will boost confidence of both domestic and global investors.
5. It is equally important to keep the workforce engaged and build an inclusive work culture and atmosphere. This, in turn, leads to enhanced customer experiences and helps the business grow.

This note has been prepared by The CFO Board, under the guidance of Mr. Abhay Mathur, Senior Vice President, Urban Company, Mr. Venkatesh Tarakkad, CFO, DealShare along with support of Mr. Karan Marwah, Partner, KPMG In India.

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