How To Be Recession Ready

June 2022

Harlem Capital

Introduction

- We have spoken with most of you over the course of the past few weeks. There were a variety of questions asked and emotions expressed so we wanted to bring everyone together for an open dialogue
- We will share our VC perspective and some other perspectives we have gathered, but there is also power in you all as founders sharing your experiences and perspectives as you are on the ground
- Most of you, us included, have not led a company through a long-term recession. The 2020 recession was deep, but quick, which most do not believe this one will be, so **we want you to be well prepared**
- **Recessions are a normal part of the business cycle.** Some of the best companies were built through the financial crisis. **Companies that navigate these times well can come out stronger**
- Fortunately, start-ups can be more agile than large companies so use this to your advantage
- Cash is going to be king in this market, but so will transparency and execution. **Do not underestimate the soft qualitative skills of being a leader in these tough times with employees, customers and investors**
- **No one knows what will happen so these are only best guesses meant to best prepare you, not scare you**

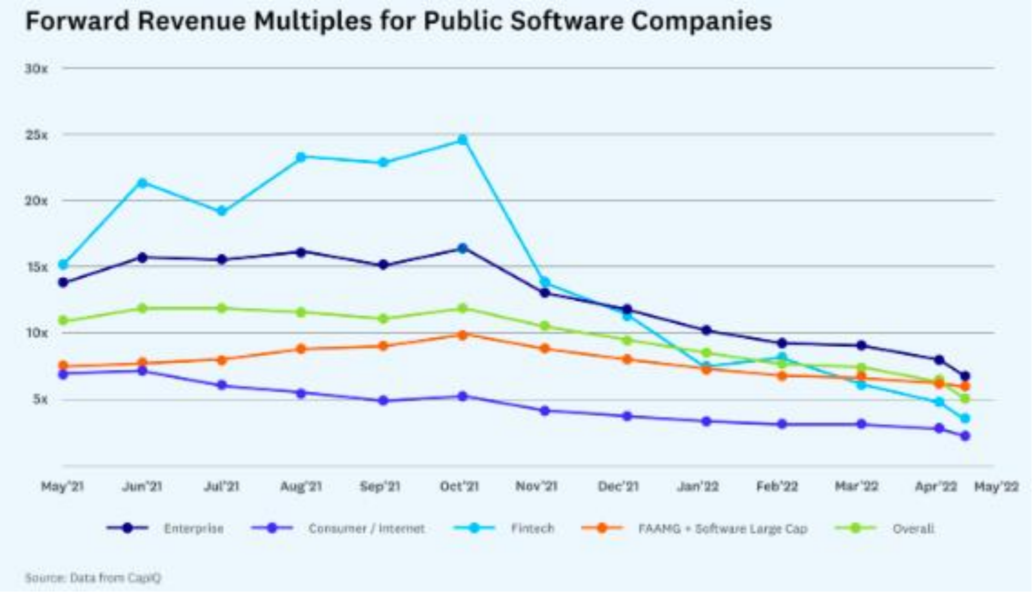
How Did We Get Here?

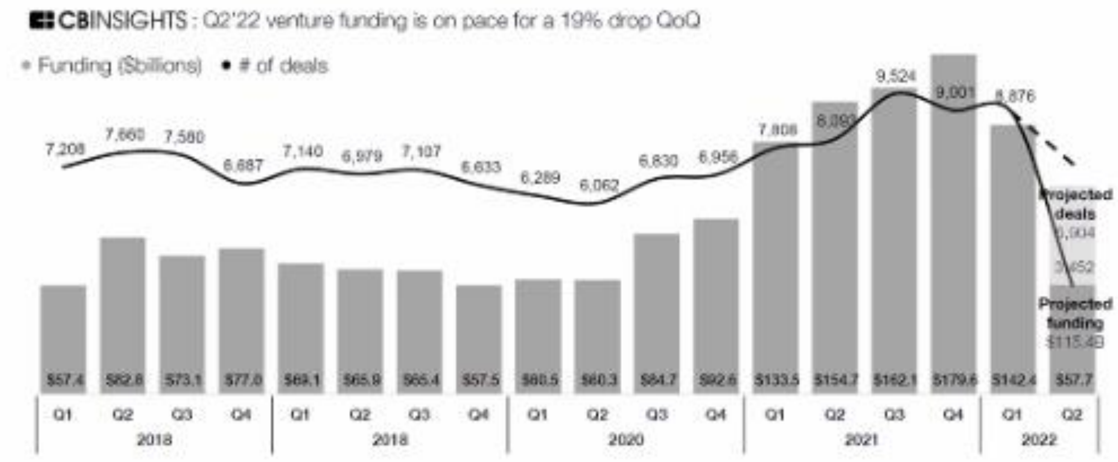
A series of events have led to a likely recession

Inflation rose to 40yr highs → The Fed increased interest rates → Equity markets dropped → Revenue multiples compressed → Growth startups are now overvalued → Late stage down rounds have begun → LP returns have declined dramatically → LPs are deploying less capital to VC → VCs are deploying less capital to startups → Startups are cutting burn to extend runway

Where Is The Market Today?

- Revenue multiples are all now below 7x, with fintech dropping from a peak of 25x. This means companies need 2-5x as much revenue for the same valuations
- Funding is expected to decline to 36% of the peak in Q2. From 2000 to 2002 there was an 87% decline in funding for context.





What Others Are Saying?

Some examples and links below

- HCP founder - "**The greats all go through this**. This is time where founders make money and show their worth."
- HCP Partner – "We saw various founders adjust or pivot during Covid in 2020. **You will be surprised by what you can do with your back against the wall**."
- Sequoia – "**It is not the strongest of the species that survive, nor the most intelligent, but the one most responsive to change**. You must prepare your mind, your team and your company. Balance optimism and realism"
- Lightspeed: "Revise your assumptions on talent. Hit the reset button on accelerating compensation and **focus on quality now that you have access to people who weren't recruitable before**."
- A16z – "Reevaluate your valuation, control your burn multiple and scenario plan for base, best and worst cases."
- Craft Ventures - "Keep Burn to ARR below 1.5-2x and push for 24 months runway"
- Redpoint – "Margins and unit economics are driving an increasing dispersion across multiples. Cash efficiency is king and more dilution should be expected."
- YC – "If your plan is to raise money in the next 6-12 months, you might be raising at the peak of the downturn. Remember that your chances of success are extremely low even if your company is doing well."

It Is Important To Extend Runway to 18-24 Months

We recommend 18+ months runway through at least December 2023, but 24 months runway should be your target. Those that are under that cash out date should raise a bridge round as soon as possible and/or do lay offs to cut burn. We highly recommend that founders create or update their monthly P&L and cashflow models. The below is a simplified version and can be found here.

Cash On Hand	$1,900,000
Average Monthly Burn	$111,000
Months to cash out	17.1
Months to product Launch (0 if post launch)	0.0
Months Post Product Launch	17.1
MRR Month 1 Post Product Launch / MRR today	$30,000
MRR Growth Rate	10%
MRR at cash out	$153,336
ARR at cash out	$1,840,034
Implied Annual growth rate	*3.1x*
MRR 6 months before cash out	$86,554
ARR 6 months before cash out	**$1,038,651**

ARR 6 Months Before Cash Out

Months to Launch	Monthly Burn: $71,000	$91,000	$111,000	$131,000	$151,000
0.0	$2,603,982	$1,486,583	**$1,038,651**	$809,652	$674,189
1.0	$2,367,256	$1,351,439	$944,229	$736,047	$612,899
2.0	$2,152,051	$1,228,581	$858,390	$669,134	$557,181
3.0	$1,956,410	$1,116,892	$780,354	$608,303	$506,528
4.0	$1,778,555	$1,015,356	$709,413	$553,003	$460,480

MRR Growth	Monthly Burn: $71,000	$91,000	$111,000	$131,000	$151,000
6%	$1,206,887	$856,705	$688,067	$590,880	$528,306
8%	$1,779,092	$1,131,406	$846,990	$692,679	$597,481
10%	$2,603,982	$1,486,583	**$1,038,651**	$809,652	$674,189
12%	$3,785,266	$1,943,674	$1,269,010	$943,721	$759,091
14%	$5,466,121	$2,529,279	$1,544,971	$1,097,011	$852,893

MRR Growth	MRR at Launch / Today: $20,000	$25,000	$30,000	$35,000	$40,000
6%	$458,711	$573,389	$688,067	$802,745	$917,423
8%	$564,660	$705,825	$846,990	$988,155	$1,129,320
10%	$692,434	$865,543	**$1,038,651**	$1,211,760	$1,384,869
12%	$846,007	$1,057,508	$1,269,010	$1,480,512	$1,692,013
14%	$1,029,981	$1,287,476	$1,544,971	$1,802,466	$2,059,962

Things To Consider If You Have To Fundraise

It is critical you are EXTREMELY transparent with your investors during these times, our recommendation is monthly updates. Ask your investors directly on their intended allocation and what concerns they have.

- Raise enough capital to get you to 24 months assuming no to limited revenue growth
- Raising externally for bridge rounds is going to be very tough so you will need existing to step up, find out their appetite sooner than later
- **Raise bridge rounds earlier so you are not at the back of the line for funds**
- Expect more dilution and lower valuations
- The bar for Series A+ rounds has certainly increased, but its unclear what the exact new metrics will be

	Great	Good	Danger Zone
Growth	3x	2.5x	Under 2x
Gross Margins	70%	50%	Under 20%
Net Dollar Retention	140%	120%	Under 100%
CAC Payback	6-12 months	12-18 months	Over 24 months
Burn Multiple	1 or less	1.0-1.5	Over 2

Source: Craft Ventures

Enterprise SaaS Benchmarks

Enterprise SaaS businesses should target a YoY ARR growth rate between 3-5x.

Key Metrics Explained

- **ARR:** Investors will look at your ARR waterfall, new ARR relative to total or old ARR, churned ARR & upsold ARR representing customers either expanding business or being sold other offerings.
- **New Logo ARR:** This measures the annual contract size of new customers. In contrast, net dollar retention focuses on the existing customer base but doesn't include new customer ARR.
- **Gross margin:** Once costs for hosting, data centers, integration & other costs are accounted for, gross margins should be >70%, & that margin should improve over time as the initial fixed costs spread over larger amounts of revenue.
- **MRR net retention:** This is a metric that factors in churn & expansion in measuring the value of a cohort of customers over time. To calculate it, take your starting MRR, add expansion MRR while subtracting churn and contraction MRR and divide that total over your starting MRR.
- **LTV/CAC:** Measures lifetime value of a customer divided by the business' cost of acquiring them.

Enterprise SaaS Benchmarks

	Initialized Series A		OpenView Series A		Bessemer $1-10M ARR		Lenny's Series A	
Metrics	***Good***	***Outstanding***	***Median***	***Top***	***Average***	***Top Quartile***	***Good***	***Great***
Finance								
ARR	$2-2.5M	>$2.5M						
YoY ARR Growth	3-4x	>4x	1.6x	2.9x	3x	>3.3x	3x	5x
New Logo ARR	$100-200k	>$200k						
Gross Margin	70-80%	>80%	78%	85%	70%	85%		
Product								
Monthly Gross Churn	1-2%	<1%					1-2%	<0.5%
MRR Gross Retention			93%	98%	85%	>95%		
MRR Net Retention	97-99%	>100%	102%	110%	140%	>145%	110%	130%
Team								
S&M Spend			33%	20%	95%	<45%		
R&D Spend			40%	26%	95%	<40%		
G&A Spend					70%	<30%		
GTM								
CAC Payback			15 mos	8 mos	12-24 mos	<12 mos	12 mos	6 mos
LTV/CAC	2-4x	4-6x			3-5x	>5x		

DTC & B2C Benchmarks

DTC & B2C businesses should target a YoY revenue growth rate between 3-4x.

Key Metrics Explained

- Run-Rate Revenue: Not all revenue is created equal. The multiples for transactional revenue typical for DTCs are lower than for SAAS or any other recurring revenue structure. In general, DTC companies should aim for $500k-$2M in revenue before their Series A.
- AOV: This varies by product. For CPG, a bigger basket-size is better than a smaller basket-size; however cheaper items make up for that by being something that you constantly need to replenish. Better yet, get consumers to sign up for a subscription.
- Gross Margin: Another key component of revenue quality is margins. The amount a CPG co can charge above the production cost is often a factor of how much of a premium a brand they are able to build through effective marketing.
- MRR Net Retention: A company's MRR one year ago divided into the current month's MRR from that same group of customers.
- User Retention: The % of users who signed up & are still active (i.e. using the product, making purchases, posting photos) 6 mos later.
- LTV/CAC: Generally, anything above 3X tends to be very good. If the number is too high it may signal that a company needs to invest more in sales, marketing and growth.

DTC & B2C Benchmarks

	Initialized Series A		Lenny's Series A	
Metrics	***Good***	***Outstanding***	***Good***	***Great***
Finance				
Run-Rate Revenue	$2-15M	>$15M		
YoY Rev Growth	3-4x	>4x		
AOV (variable)	$150-300	>$300		
Gross Margin	40-50%	>50%		
Product				
Monthly Gross Churn (SaaS)			3-5%	<2%
MRR Net Retention (SaaS)			55%	80%
User Retention (SaaS)			40%	70%
User Retention (Social)			25%	45%
User Retention (Transactional)			30%	50%
DAU/MAU				>50%
GTM				
CAC Payback			6 mos	<1 mos
LTV/CAC	2-3x	>3x		

Marketplace Benchmarks

Marketplace businesses should target a YoY revenue growth rate between 3-4x.

Key Metrics Explained

- **Run-Rate Revenue:** Net revenues are generally the rubric that investors look at and you should outline both the gross & net revenue numbers. While the revenue is transactional in nature, there should be recurring business numbers to point to that demonstrate stickiness and loyalty that come from the convenience of using the platform.
- **Gross merchandise value (GMV):** This is the total value of all merchandise, labor, services sold through a marketplace before the business' take rate or expenses are accounted for. Depending on the take rate, this would typically be 2-5x your net revenue.
- **Take Rate:** The % of GMV collected by the marketplace. The take rate typically falls between 10-30% with higher take rates for more exclusivity. In the beginning, your business' take rate might be set lower in order to capture more market share & customers. For larger markets or markets with larger AOVs, take rates tend to be lower while businesses targeting something more niche, take rates tend to be higher. We often see co's at this stage optimizing for transactions (GMV) rather than take rate.
- **YOY GMV Growth:** For an early-stage marketplace business, GMV needs to be expanding at a higher rate than revenue. The market you are trying to win needs to be expanding at a greater rate in order to generate more dollars and then over time as the flywheel of supply & demand gets set in place, the network effects of marketplace can fuel acceleration of growth.

Marketplace Benchmarks

	Initialized		FJ Labs
	Series A		Series A
Metrics	*Good*	*Outstanding*	*Mid 50%*
Finance			
Run-Rate Revenue	$2-5M	>$5M	$600k-3M
YoY Rev Growth	3x	>3x	
GMV	$5-7M	>$7M	$6-12M
Take Rate	15%	15%	10-25%
YoY GMV Growth	3-5x	>5x	3-4x
Gross Margin	50-60%	60-80%	60-70%

Things To Consider If Doing Lay Offs

Make sure to be a human first. **You do not want to be reading a script on zoom.**

- Prep your speech, emails, legal docs, severances, etc. at least 1-2 weeks in advance
- Have your investors review these documents
- Do ONE all hands meeting in the morning
- **Lay off 10-25% more than you are comfortable with**, you don't want more than one round of layoffs
- Send out an email detailing everything immediately after the meeting
- Hold open office hours for remainder of the day after you make the announcement
- **Talk to each remaining team members one on one or have managers do this for those remaining**
- **Reaffirm your mission and values to align the team and then ask for their commitment**
- Determine the right incentives for the remaining employees and provide an updated org chart
- HCP founder: "**Biggest mistake we made was hiring to solve a problem vs seeing if there was a process or product to solve a problem.** Easy to solve problems with human capital, which is obvious but expensive."
- HCP founder: "**If you are reading this, we are betting on you. We cannot accomplish this without you, your talent and dedication.** We strongly believe you are part of the solution to get us past a challenging phase."

Questions to Ask Yourself

For my business

- **How will a 12+ month recession impact my customer base? Pricing? Churn? Net Retention?**
- **If I haven't launched yet, are there any assumptions that need to be adjusted?**
- How do I get to 18-24 months runway? Lay offs? Raising? Selling?
- Is my team all A or B players? I only need stars during tougher times. Can I do more with less?

For myself as CEO

- Where are you focused?
- What is the opportunity in this?
- What can you do now for next steps?
- Have you given yourself time to grieve laying off employees?
- **Where is your energy going today and how can you reframe that energy? Does it need to be moved?**
- **What are you learning from this experience? Make sure you are tracking your lessons**

You Are Not Alone.

Harlem Capital