9. Financial Analysis

The following financial analysis is derived from a product development and marketing analysis, based on a five-year time frame. The financial analysis is based on conservative numbers and projections are consistent with those of comparable network software companies.

MultiLink Distributed Solutions, Inc. is seeking $2,100,000 of capital investment. Detailed financial analysis and market research indicates that, given a $2,100,000 capital investment, MultiLink Distributed Solutions, Inc. will be cash flow positive by quarter 7, and achieve profitability by quarter 9. By the end of year five, MultiLink projects a cumulative after-tax net income of $21.2 million.

MultiLink Distributed Solutions, Inc. has filed as a "C" type California corporation, primarily to take advantage of free transferability of ownership and to experience limited liability.

MultiLink's mission is to establish a presence as the leading vendor for reliable and mission-critical group communication software. Survival of networking companies relies heavily on offering excellent customer support and a well tested product. MultiLink will achieve this objective by reinvesting heavily into product testing and technical support throughout the first five years. Capital infusion in the first year will be primarily dedicated to product developing and testing. After the initial product release in year 1, the company will shift emphasis to sales and technical support.

9.1 Rate of Return on Investment:

For investors, their $2.1 million investment will provide the following rate of return on investment.

Assumptions

- MultiLink Distributed Solutions, Inc. will go public at the end of five years
- After tax net income is discounted at a rate of 25% per year
- 40% investor equity ownership

Rate of Return on Investment (over 5 years)

- P/E ratio of 10 will yield a 560% ROI
- P/E ratio of 20 will yield a 1160% ROI
- P/E ratio of 30 will yield a 1750% ROI

9.2 Projected Revenues

In accordance with Phase I of the marketing plan, the first six months will concentrate on testing and software verification. Product sales of the development copies begin in month 10

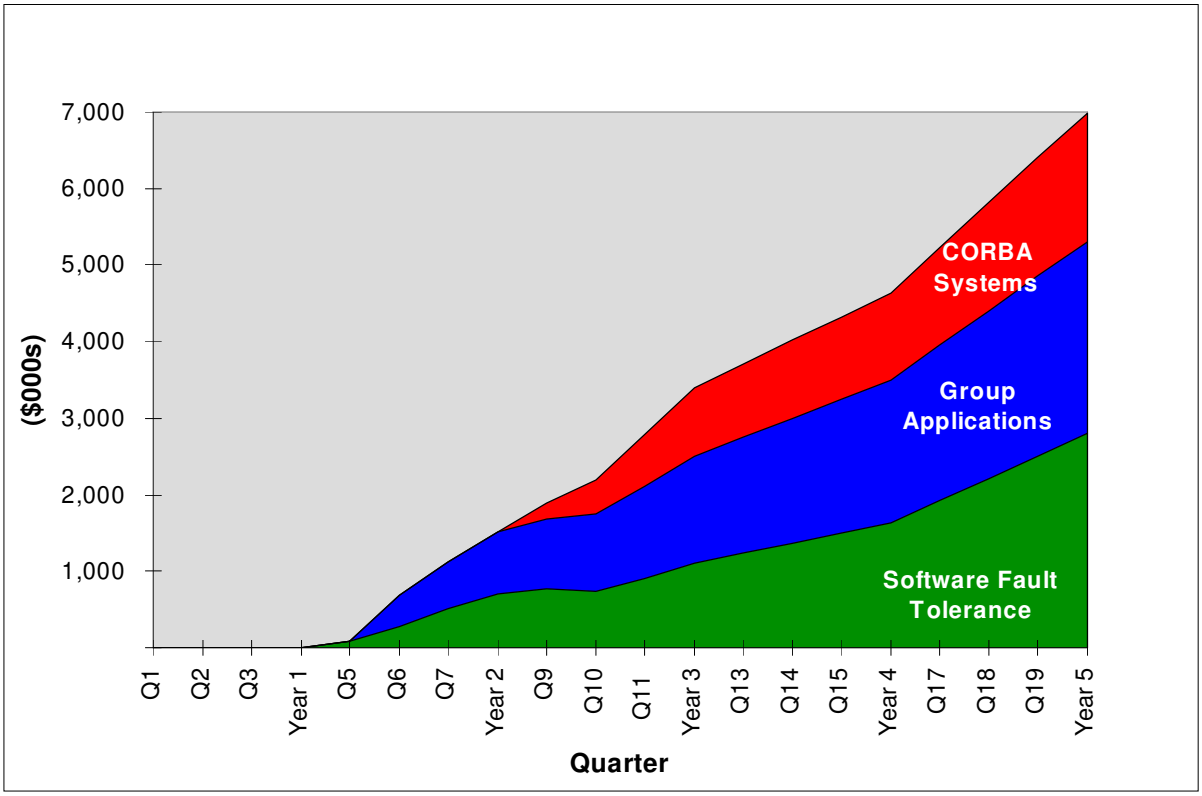

Figure 9.1: Sales Projections

of year one and sales continue to grow on a conservative though steady basis throughout five years.

Phase II, beginning in year three, entails focused sales efforts aimed at the CORBA based distributed computing market. The market for CORBA is estimated to reach approximately 1 billion in sales by 1999. MultiLink Distributed Solutions, Inc. plans to target 1% of this market, by offering a product which provides software fault tolerance, object replication, and secure communication.

The first two quarters will be devoted to product development. MultiLink intends to achieve $28,000 in sales the first year, $3.4 million in year two, $10.3 million in year three, $18.5 million in year four, and $28.0 million in year five. The first year sales are only of development copies, which cost $3500 each.

Year three revenue growth is attributed to expansions in Phase I, plus the addition of Phase II CORBA sales, projecting 15,000 units at $150 per unit. Sales projections are based on conservative estimates and sales may well exceed expectations. Figure 9.1 summarizes the projected sales revenues for the three markets.

9.3 Projected Operating Expenses

Approximately two thirds of operating expenses are dedicated to salaries, payroll taxes and computer equipment. Over time, MultiLink will increase salaries and concentrate investment

in development, technical support staff and marketing and sales. The projections assume a tax rate of 40%. All other expenses are consistent with software start-ups of this size. If revenues grow slower or faster than projected, the company will adjust the indirect costs accordingly in order to stay cash flow positive. Operating expenses as a percentage of revenue are 4130% in year one, 54% in year two, 28% in year three, 26% in year four, and 24% in year five.

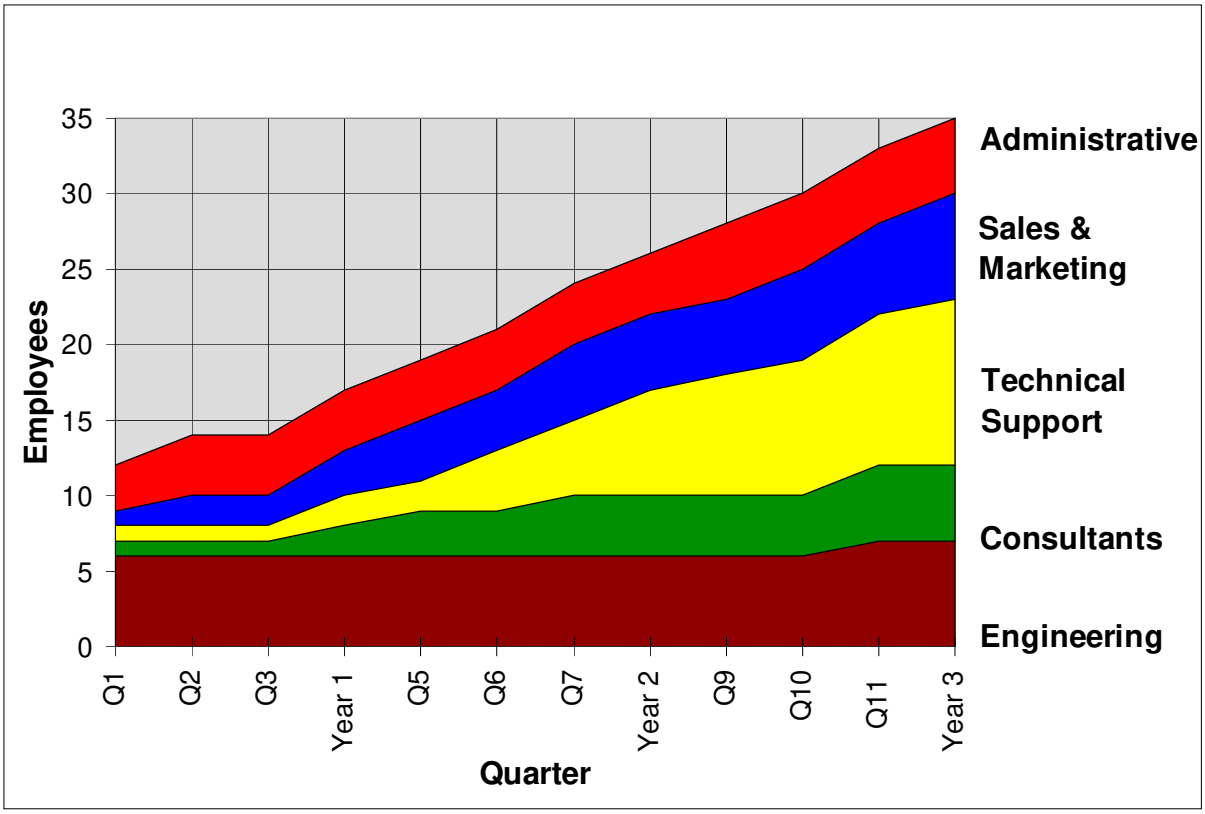

Figure 9.2: Headcount Projections

Personnel are the biggest operating expense, accounting for over 50% of expenses. Hiring is concentrated primarily in the areas of development, technical support, consultants and marketing and sales. Figure 9.2, above, shows the projected headcount for the first three years.

For the first six months, operating expenses are concentrated on development and testing of the product. Sales and marketing is key, and this department grows quickly as well. As the company matures, more money is spent on consultants, who are actually revenue generators, and on the company's commitment to technical support. Administration accounts for a seemingly high percentage of operating expenses because expenses for rent, human resource locators, and legal and accounting professionals are all included in this category. Figure 9.3, below, shows the breakdown of operating expenses by department.

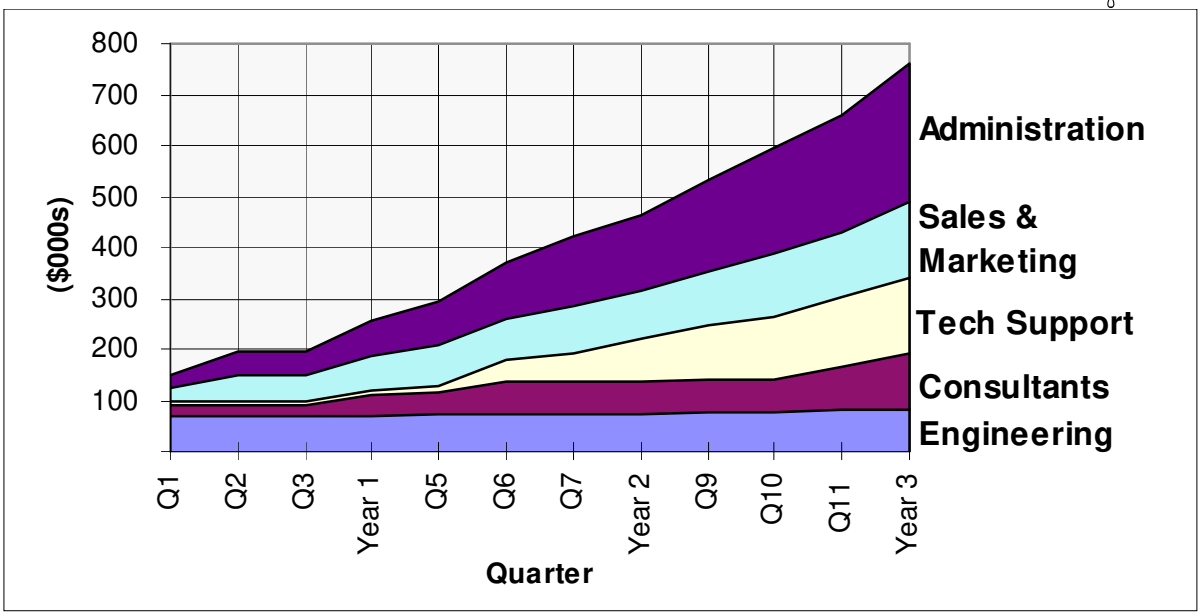

Figure 9.3: Operating Expenses by Department

A key question is at what point the company achieves break-even. This occurs when revenues become the same as expenses. Figure 9.4 shows both the projected revenues and expenses for the company for the first three years. This graph shows that the company will break even in the seventh quarter of operation, and will remain profitable from then on.

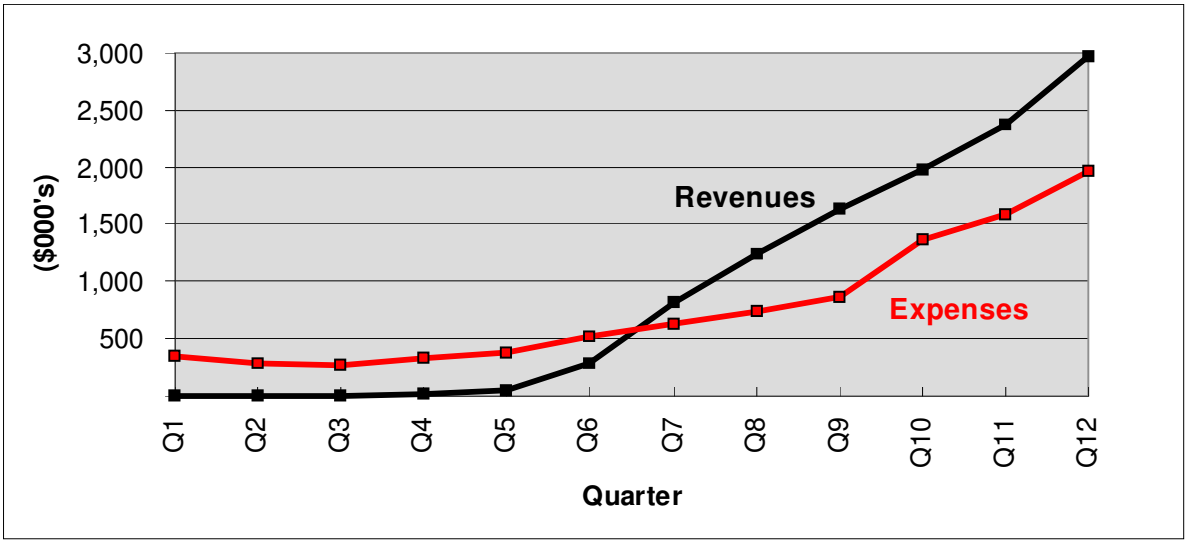

Figure 9.4: Expenses and Revenues

9.4 Cash Flow Analysis

In terms of the success of the company, the cash flow is of paramount importance. Revenues and expenses are important, but only so long as the company has at least some money left. In

the cash flow analysis, the projections assume that expense accounts are paid on time or within 30 days, and revenue accounts are paid within 60 days. The company also assumes that leasing capital equipment is not available to us. In practice however, following year three, MultiLink intends to lease additional computers, thereby improving the cash flows relative to current projections.

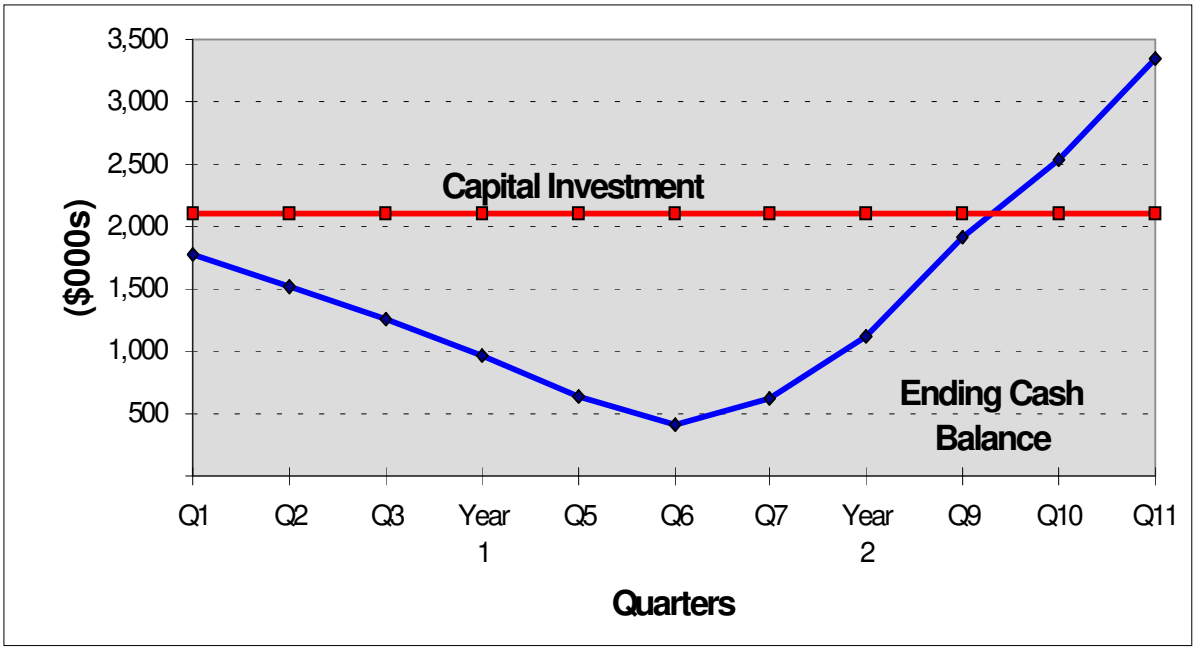

Figure 9.5: Capital Investment and Ending Cash Balance

MultiLink Distributed Solutions, Inc. is seeking $2,100,000 total capital infusion in order to support the development, testing and marketing costs necessary for a successful product launch. In order to ensure the capability to cover costs within the first year and a half, MultiLink Distributed Solutions, Inc. requires a commitment of $2,100,000 capital investment before the first month of operation.

Given this investment, the projected ending cash balance within the first year is relatively healthy due to investors' capital infusion. Following quarter 7, dependence on external investment is replaced with revenues from Phase I. The revenues from Phase I will then fund expansion for Phase II. The cash flow projections show that the company will never drop below a cash balance of $400,000. This cushion is necessary in case the initial sales take up to a quarter longer than expected to develop. In addition, this reserve will allow the company to stay solvent based solely on sales in the Software Fault Tolerance market. Figure 9.5 shows the results of the cash flow analysis.

Due to substantial investment in development and testing throughout the first year, the company is projected to break even in quarter 6 and realize its first cumulative profit in the beginning of quarter 10 when its cash balance exceeds $2,100,000. Following quarter 7, revenue consistently exceeds operating expenses. Gross margin as a percentage of revenue is

90% in year one, 86% in year two, 86% in year three, and 86% in year four and 87% in year five.

9.5 Projected Net Income

Based on the previous projections for revenues and expenses, figure 9.6 shows the projected total revenues, gross margin, and net income for the company. Net income in year two is $1.1 million, $3.6 million in year three, $6.8 million in year four, and $10.8 million in year five. Cumulative profit in year five is $21.2 million.

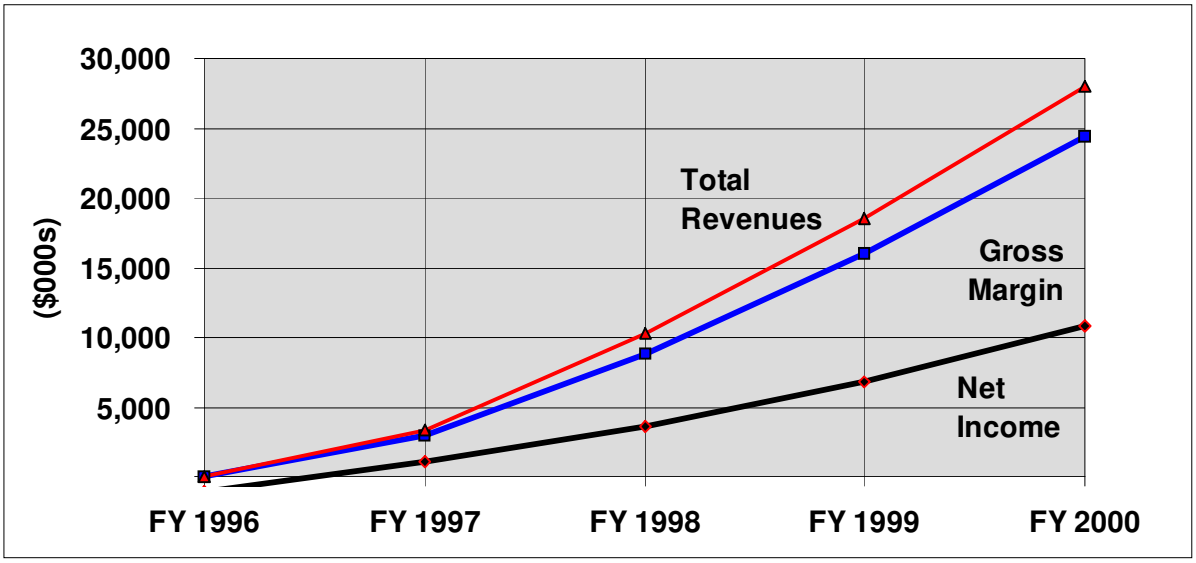

Figure 9.6: Net Income vs. Total Revenue

9.6 Present Value of Company

The present value of MultiLink Distributed Solutions, Inc. is based on the previous net income projections. The present value is based on the cumulative discounted cash flow, measured over 3, 4, and 5 years. The future cash flow is discounted at 0%, 15%, 25%, and 40%.

Discount Rate	3 Years	4 Years	5 Years
0 %	$3,622	$10,384	$21,205
15%	$2,224	$5,949	$11,084
25%	$1,566	$4,079	$7,219
40%	$862	$2,263	$3,776

Figure 9.7: Present Value of Company (in thousands)

9.7 5 Year Financial Summaries

This section contains the predicted financial summaries for the first five years of MultiLink's operation. The detailed financial analysis is contained in Appendix B.

9.7.1 Income Statement

	FY 1996	FY 1997	FY 1998	FY 1999	FY 2000
Revenue					
Software Fault Tolerance Sales	$28,000	$1,139,200	$2,627,800	$4,692,000	$7,254,000
SFT Consulting	$0	$446,400	$895,200	$1,804,800	$3,960,000
ISV Sales	$0	$1,800,000	$4,500,000	$7,500,000	$10,000,000
CORBA Sales	$0	$0	$2,250,000	$4,500,000	$6,750,000
Total Revenue	$28,000	$3,385,600	$10,273,000	$18,496,800	$27,964,000
Cost of Goods Sold	$2,924	$466,652	$1,422,407	$2,517,960	$3,620,960
Gross Margin	$25,076	$2,918,948	$8,850,593	$15,978,840	$24,343,040
% of Revenue	90%	86%	86%	86%	87%
Operating Expenses					
Engineering	$278,250	$291,466	$317,284	$590,684	$835,786
% of Revenue	994%	9%	3%	3%	3%
Technical Consultants	$89,155	$231,326	$327,158	$358,671	$562,042
% of Revenue	318%	7%	3%	2%	2%
Technical Support	$24,274	$192,958	$510,568	$1,019,623	$1,409,827
% of Revenue	87%	6%	5%	6%	5%
Marketing/Sales	$181,239	$479,455	$890,018	$1,683,866	$2,435,768
% of Revenue	647%	14%	9%	9%	9%
Administration	$597,355	$645,032	$874,033	$1,230,576	$1,493,625
% of Revenue	2133%	19%	9%	7%	5%
Total Operating Expenses	$1,170,273	$1,840,237	$2,919,061	$4,883,420	$6,737,048
% of Revenue	4180%	54%	28%	26%	24%
Income Before Int & Taxes	($1,145,197)	$1,078,711	$5,931,532	$11,095,420	$17,605,992
% of Revenue	N/A	32%	58%	60%	63%
Interest Rev	$55,523	$26,322	$89,072	$174,962	$428,579
Income Before Taxes	($1,089,674)	$1,105,033	$6,020,604	$11,270,382	$18,034,571
Tax Exp	$0	$6,144	$2,408,242	$4,508,153	$7,213,828
Net Income	($1,089,674)	$1,098,890	$3,612,362	$6,762,229	$10,820,742
% of Revenue	N/A	32%	35%	37%	39%

9.7.2 Balance Sheet

	FY 1996	FY 1997	FY 1998	FY 1999	FY 2000
ASSETS					
Current Assets					
Cash	$963,983	$1,123,770	$4,374,042	$10,707,075	$20,759,409
Net Accounts Rec	$17,465	$996,639	$2,236,182	$2,930,316	$4,437,097
Inventory	$0	$57,750	$148,750	$206,458	$268,396
Total Current Assets	$981,448	$2,178,159	$6,758,974	$13,843,850	$25,464,902
Gross Fixed Assets	$105,525	$142,125	$186,875	$312,400	$439,600
Less Accum Depreciation	$18,660	$46,792	$83,173	$147,798	$237,623
Net Fixed Assets	$86,865	$95,333	$103,702	$164,602	$201,977
TOTAL ASSETS	$1,068,312	$2,273,492	$6,862,676	$14,008,452	$25,666,879
LIABILITIES					
Short Term Liabilities					
Accounts Payable	$30,303	$115,704	$242,848	$309,347	$437,798
Salaries Payable	$27,683	$42,429	$52,959	$88,259	$121,075
Taxes Payable	$0	$6,144	$837,897	$1,127,038	$1,803,457
Total Short Term Liabilities	$57,986	$164,276	$1,133,704	$1,524,645	$2,362,329
Long Term Liabilities					
Long Term Debt	$0	$0	$0	$0	$0
Total Long Term Liabilities	$0	$0	$0	$0	$0
TOTAL LIABILITIES	$57,986	$164,276	$1,133,704	$1,524,645	$2,362,329
Equity					
Common Stock	$0	$0	$0	$0	$0
Preferred Stock	$2,100,000	$2,100,000	$2,100,000	$2,100,000	$2,100,000
Retained Earnings	($1,089,674)	$9,216	$3,621,578	$10,383,807	$21,204,550
Total Equity	$1,010,326	$2,109,216	$5,721,578	$12,483,807	$23,304,550
LIABILITIES & EQUITY	$1,068,312	$2,273,492	$6,855,282	$14,008,452	$25,666,879

9.7.3 Statement of Sources and Uses

	FY 1996	FY 1997	FY 1998	FY 1999	FY 2000
BEGINNING CASH	$0	$963,983	$1,123,770	$4,374,042	$10,714,469
Sources of Cash					
Net Income	($1,089,674)	$1,098,890	$3,612,362	$6,762,229	$10,820,742
Add Depr/Amort	$18,660	$28,131	$36,381	$64,625	$89,825
Equity Investment	$2,100,000	$0	$0	$0	$0
Plus Changes In:					
Accounts Payable	$30,303	$85,401	$127,144	$66,499	$128,450
Salaries Payable	$27,683	$14,745	$17,924	$35,300	$32,815
Taxes Payable	$0	$6,144	$831,753	$289,141	$676,419
Long Term Debt	$0	$0	$0	$0	$0
Total Sources of Cash	$1,086,973	$1,233,311	$4,625,565	$7,217,795	$11,748,252
Uses of Cash					
Less Changes In:					
Net Accounts Rec	$17,465	$979,174	$1,239,543	$694,134	$1,506,781
Inventory	$0	$57,750	$91,000	$57,708	$61,938
Gross Fixed Assets	$105,525	$36,600	$44,750	$125,525	$127,200
Total Uses	$122,990	$1,073,524	$1,375,293	$877,368	$1,695,918
CHANGES IN CASH	$963,983	$159,787	$3,250,272	$6,340,427	$10,052,334
ENDING CASH	$963,983	$1,123,770	$4,374,042	$10,714,469	$20,766,803