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Axonify: Budgeting for rapid growth

Howard Armitage, Dave Pooley, and Alan Webb wrote this case solely to provide material for class discussion. The authors do not intend to illustrate either effective or ineffective handling of a managerial situation. The authors may have disguised certain names and other identifying information to protect confidentiality.

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It was Friday afternoon in late November of 2016, and Dave Pooley, chief financial officer (CFO) at Axonify, was finalizing his list of “to do” items for what would likely be a very busy weekend at the office. Pooley’s first task would be to review the budget estimates that he was expecting from the marketing department by the end of Friday; these would include the total incremental costs that would need to be incurred in 2017 to grow the customer base and the budgeted average cost of acquiring new customers. Senior members of Axonify’s management team and the board had agreed on an aggressive target of generating US$10 million[[1]](#footnote-1) in annual revenue from new customer acquisitions in 2017. However, the board was firm that, in order to achieve the company’s profitability objectives, the average cost of acquiring a customer (CAC) should not exceed $150,000 in 2017. Pooley knew there was a delicate trade-off between the need to increase the customer base to meet revenue growth targets and the need to control costs. He was hopeful that the budget estimates he would be receiving from marketing would strike the right balance.

Pooley’s second task was to review the budgeting approach currently used at Axonify. Both Pooley and Axonify’s chief executive officer (CEO), Carol Leaman, had great trust in the senior management team and, as a result, had never used a rigid top-down budgeting approach. Instead, budget development was a collaborative process with division heads having considerable autonomy to come up with their own budget estimates (in the context of the overall goals for revenue growth established by the CEO and the board). Moreover, Pooley did not adhere to a detailed line-by-line review of actual results against budget. While actuals were reviewed against the budget on a quarterly basis, Pooley employed an informal approach only, following up with specific managers when deviations from budget were significant. This somewhat “relaxed” approach to developing and using the budgets had served Axonify well through its start-up phase but, as the company continued to grow, Pooley had begun to wonder whether changes were needed.

BACKGROUND

Axonify was an Ontario-based technology company that was revolutionizing the corporate learning environment. The company had developed an elaborate online employee knowledge platform that utilized repeated short bursts of self-administered learning and employed gamification techniques, in which learning activities were embedded in simple games to increase user engagement.[[2]](#footnote-2) From a modest beginning, Axonify had grown from having a single customer to serving a large portfolio of clients, including several Fortune 1000 companies.

Axonify was formed in 2011, when Carol Leaman and Christine Tutssel purchased a small marketing business from John and Rebecca Short. The Shorts, through their marketing business, had been successfully implementing an employee knowledge platform at a full-service automotive parts and service aftermarket chain headquartered in Philadelphia, Pennsylvania. While the business had the potential to scale to other clients, the owners felt it was an opportune time to approach more knowledgeable, local tech- and business-savvy entrepreneurs about how to leverage scalable cloud-based technologies. They approached Carol Leaman, a well-known Waterloo, Ontario-based entrepreneur who had recently sold her start-up, PostRank, to Google and who had also successfully built and sold a manufacturing software company, RSS Solutions, and a virtual reality player, Fakespace.

With the Shorts retaining some ownership of the business, Leaman and Tutssel ended up buying the majority of the business with Leaman serving as CEO. They successfully obtained their first $1.5 million financing injection from venture capitalists (VCs) in California. This capital provided the seed funds necessary to redevelop the existing software and expand the business. As the revised product began to emerge, Tutssel began the task of convincing potential corporate clients that the Axonify concept of ongoing learning was a driver of enhanced performance that could be personalized, engaging, and efficiently incorporated into an employee’s workday.

In 2013, their efforts paid off when Axonify landed Walmart as a marquee client. As a result of this acquisition, Axonify was able to both raise an additional $3.5 million from a venture capitalist in New York and leverage the Investing in Business Innovation funding program offered by the Government of Canada to support high-growth businesses in southern Ontario. Axonify received an additional $27 million investment from JMI Equity and BDC Capital in October 2016.

From its modest beginnings, Axonify ended 2016 with an impressive $11.7 million ($8 million in 2015; $4.5 million in 2014) in annual recurring revenue (ARR) and total headcount of 105 (60 in 2015; 30 in 2014).[[3]](#footnote-3) Leaman estimated that nearly 160 employees would be on board by the end of 2017. Axonify’s success had been accomplished by a leadership team that featured extensive experience. Senior executives were serial entrepreneurs who were familiar with the issues facing rapidly growing organizations.

Reporting directly to Leaman was the CFO, the chief operating officer (COO), and six vice-presidents (VPs): VP Development, VP Products, VP Human Resources, VP Professional Services, VP Marketing, and VP Business Operations. In a recent article in Techvibes, Leaman described his view of the importance of a coherent culture and values in achieving and continuing Axonify’s growth and success:

I’m a person who firmly believes that every single human being comes to work every day really wanting to do good things . . . and in my experience when you trust people to come to work with that attitude they perform in ways that you just don’t even expect.[[4]](#footnote-4)

FINANCIAL REPORTING SYSTEMS

Pooley explained that the accounting system in an application based on software as a service (SaaS), such as the application used by Axonify, was straightforward:

We operate on Excel and QuickBooks. We don’t use any ERP [enterprise resource planning] systems and typically won’t until we get bigger. I think you will find that most firms at our stage use generalized packages like Excel because they are adaptable and because we are not yet being driven by MCS [enterprise resource planning] . . . structures that already exist.

He continued:

We might consider something more integrative next year that would tie in with [the] sales force (a cloud-based CRM [customer relationship management] for small business) but, at the moment, it’s really straightforward from the revenue, sales, and accounting point of view. For example, we charge annually in advance⎯say $1 million for a one-year contract⎯drop this into deferred revenue and recognize one-twelfth every month; that’s it. My only complexity at the moment stems from my board wanting U.S. reporting because all my QuickBooks are in Canadian dollars. But other than that, it’s straightforward.

Financial statements that were based on generally accepted accounting principles (GAAP) were prepared but seldom discussed at board meetings. More important was focusing on the key metrics on which creditors and VCs evaluated Axonify. Pooley explained:

For example, we just had a VC investor in here very interested in our SaaS metrics. He wanted to know: “What’s the cost of acquiring a customer?”; “What’s the LTV [Lifetime Value] . . . associated with the contracts we are doing?”; and “What’s the churn rate” ([percentage] of customers lost in a year)?” They didn’t care about GAAP revenue⎯all they wanted to know was what was our ARR and what was the annuity pool that we’re building in terms of our ARR value and how stable it was. That was straightforward for me to produce.

Pooley explained that his top priority as CFO was to support the sales team by providing any information it needed to close a deal. This support involved both assisting in the contract and legal work involved in client acquisition as well as providing analytical support. Pooley spent considerable time ensuring he understood the sales process, and noted:

If we insert a sales rep, we need to have a good idea what our output will be. It was less predictable than required. If we were going to go out and raise $10 [million] to 15 million, then I needed to be able to clearly show what we’re going to use that money for and how quickly we’re going to get a return on that investment.

Pooley offered that, unless the board requested specific financial statement information, in fast-growing young firms, these kinds of analytics typically took precedence over GAAP-based financial statements.

THE BUDGETING SYSTEM

Budgeting was a central element of the management control system at Axonify, and served two key purposes. First, budgeting formalized the financial targets company leaders needed to achieve and, in so doing, provided the benchmark against which actual performance was evaluated. The nature of the company’s financing was such that it needed to respond to investor and board expectations, both of which assumed exponential growth. The budgeting process reflected this assumption. The process began with the CEO, the COO, and the CFO asking, “What do we need to do next year to meet the expectations of our board and venture capitalists? Is it realistic?” For example, the VCs expected, at a minimum, a doubling in ARR, year over year. These were aggressive goals so it was a stretch to actually attain these results. Pooley explained, “I needed to do a balancing act. I needed to be able to show a VC that we are hitting our budgets while challenging ourselves internally to hit the big numbers our investors are looking for. The budgeting process always involved a push and pull with our investors.”

Second, the budget was an important operational planning tool. Once the targeted ARR was established, communications with the VPs began. Targets were provided, and discussions commenced regarding what would be required to achieve these goals. For example, in 2017 Axonify expected to achieve $20 million in cumulative ARR. Pooley gave an example of this communication:

We go to Laura, head of marketing, and we say “Laura⎯we need to figure out how many customer leads do we need to meet our revenue objective?” She then coordinates with each manager within her group, asking each how much they are going to need to accomplish the revenue objective. So, the budgeting exercise gets quite granular at the division level.

Expanding on this example, the VP Marketing, Laura Martin, indicated that she had developed a detailed analytical approach starting with the incremental ARR (e.g., $8 million) required to meet the year’s total ARR target (i.e., $20 million). The approach comprised two key elements.

Firstly, about $2 million of the incremental ARR would likely come from upselling additional services to existing customers, leaving approximately $6 million to be generated from new customers. Upselling involved offering existing customers features that enhanced the functionality of the learning platform. Based on the $6 million incremental ARR required from new customers, Martin would use the historical ARR generated by each customer (e.g., $150,000) to estimate the total number of new customers that Axonify needed to acquire in the coming year (e.g., 40).

Secondly, past experience indicated that some of these new customers (e.g., 5) were likely to be generated indirectly through a network of partner companies that referred clients to Axonify, while others (e.g., 5) would come from contacts directly generated by Leaman or other members of the senior management team. These efforts resulted in the net number of estimated new clients (30) that needed to be generated through the combined efforts of the opportunity development representatives (ODRs) in the marketing group and the sales representatives. Thus, of the $6 million total targeted incremental ARR in this example, Martin estimated that 75 per cent (i.e., $4.5 million) would need to come through the efforts of the ODRs and sales reps in growing the customer base.

In describing the process, Martin explained that the ODRs’ role was to identify potential customers through various marketing-qualified leads (MQLs), such as direct inquiries (e.g., email from an interested potential customer), the Internet (e.g., webinar attendance, video views), trade show meetings, and social media (see Exhibit 1). ODRs would then make first contact with potential customers by way of an “introduction call” and follow up with a “discovery call” to gather and provide additional information. Those who participated in a discovery call and remained interested in the product were identified as “passed leads.” These were then transferred to the sales reps for in-depth follow-up (e.g., additional calls, meetings, and product demos), with the ultimate goal of closing the deal. Using historical results as a guide, Martin estimated that about 10 per cent of passed leads were converted into new customers, which meant 300 “passes” would be needed to produce 30 new customers. This conversion rate was subject to some yearly fluctuation but tended to diminish over time. Identifying passed leads was labour-intensive; according to Martin, generating 300 passes could require follow-up by ODRs on thousands of initially qualified leads. Martin’s analysis was based on the assumption that each ODR would be able to generate about five passed leads per month, which meant that five ODRs would be needed to generate 300 passes if incremental ARR from new customers was targeted at $4.5 million (300 × 10% × $150,000). Also, assuming a 2:1 ratio regarding the time required by sales reps to close a deal (i.e., convert a pass into a new customer) relative to the time needed by ODRs to generate the passed leads, 10 sales reps would be needed.

This example illustrates how the budgeting process at Axonify, starting with an ARR target, led to an analysis of the relationship between ODRs developing customer leads, sales representatives generating passed leads, and Axonify acquiring new customers. In turn, these relationships were translated into budgeted expenses in terms of their impact on headcount, the cost of generating qualified leads, the cost of follow-up by ODRs with information and discovery calls, and the costs incurred by sales representatives working with passed leads. This analysis was critical in allowing management to estimate the average cost of acquiring customers, a key metric for SaaS companies such as Axonify.

Developing the operating budget was an iterative process beginning with each VP being given a spreadsheet that contained historical data on departmental spending, the number of personnel currently employed, and related salary information. Dialogue between the VPs and their departmental managers regarding budget development focused on the implications that attaining the ARR target would have for headcount growth in their functional area and the estimated impact on expenses in the coming year. The final budget emerged from this iterative process and was the product of the senior management team’s beliefs about what the company should strive to achieve in conjunction with input from the CEO and the CFO. For a rapidly growing company such as Axonify, it was often difficult to rely on historical results to make informed projections about future revenues and expenses. However, Leaman had placed experienced people at the head of each division and she trusted her VPs would develop realistic budgets based on actual needs. However, she also held them accountable for any significant variances from budget. Pooley added, “We run a very tight ship because of the people that are helming each of the groups. I’ve got a lot of peace of mind that if someone asks for something, or for an additional hire, it’s because they need it and they understand the value associated with it.”

Pooley pointed out that he took a conservative view of the budget development process, yet believed that it was important to create a buffer in case there was a need to make unplanned expenditures. He explained that he was comfortable with this approach because of the highly experienced management team in place at Axonify. Specifically, he was confident that these managers would use the buffer only to pursue initiatives that were likely to add value to Axonify’s operations. Moreover, Martin noted that, because of the high level of trust placed in the VPs to make decisions that were in the best interests of the company, she had no objections to shifting budgets among expense categories if the need arose.

On a quarterly basis, Pooley distributed reports comparing the budgeted numbers with the actual numbers to the VPs of each unit. In an environment in which rapid change was the norm, there was a tacit understanding that deviations from budget were likely to occur. Pooley described the process of preparing quarterly performance reports as follows:

I did my analysis against our budget, usually on a quarterly basis although I checked on our cash flow on a month-to-month basis. Reporting to the rest of the group had been a work in progress. This was the first year where we’ve created enough accounts in QuickBooks to provide the necessary granularity for distributed reports. As we grow, this will improve. At the moment, I’m focused on tracking how we’re proceeding against our budget at a high level. How is our company doing as a whole entity? Are we in the cash position we said we were going to be in? Where are we from a revenue perspective? As long as these are OK, I’m not stressing too much and I’m not tracking each division too closely. In the future, we will be providing those reports to each department head in terms of where they spend their money and how does that align against their budgets. But, for now, if they don’t hear from me, they can assume that they are in the clear!

THE BUDGETING CHALLENGE

Based on board-approved discussions, the senior management of Axonify had set the goal of $10 million net new ARR in the next fiscal period. Of this amount, $3 million was expected to come from upselling activities, with the remainder coming from new customer deals generated by the marketing department. An important metric of any SaaS business, such as Axonify, was the CAC. The Axonify board had set a ceiling on this number, indicating that the average CAC for the year should not exceed $150,000.

The marketing team had been tasked with estimating the operating costs associated with generating the MQLs required to achieve the company’s goals so that Axonify could determine whether this estimate was in line with the CAC. It had been determined that the average cost of an MQL was approximately $150. The marketing department further indicated that the average deal size (in dollars) in terms of the ARR of new customers acquired in 2017 was expected to be the same as it was for new customers acquired in 2016. They also noted that, in 2016, to achieve approximately $4 million in ARR from 27 new customers (a further $1.3 million of incremental ARR in 2016 was generated through upselling to existing customers), the marketing team created 7,472 MQLs which led to 454 introduction calls, 214 became discovery calls of which 173 were passed leads. Other marketing costs included in the calculation of an average CAC were marketing salaries ($2 million), sales salaries ($2 million), and other sales operating costs ($1 million).

Having reviewed the budget estimates and approach, Pooley wondered whether any changes were needed as the company continued to grow.

Exhibit 1: Axonify’s Sales Generation Process

Marketing Qualified Leads

Introduction Calls

Discovery Calls

Passed Leads

New Client Sales

Source: Compiled by authors based on discussions with Axonify management.

1. All currency amounts are shown in U.S. dollars unless otherwise specified. [↑](#footnote-ref-1)
2. For a review of how the Axonify system operated and for the underlying theories on which it was based, see Connie Malamed, “Axonify Review: An Effective Model for Online Learning,” [http://theelearningcoach.com/reviews/software/AXONIFY-review/](http://theelearningcoach.com/reviews/software/axonify-review/). [↑](#footnote-ref-2)
3. Clients were required to pay an annual fee for the right to use the knowledge platform on an ongoing basis. Therefore, revenue from retained clients was described as “recurring.” [↑](#footnote-ref-3)
4. Ibid. [↑](#footnote-ref-4)