Profitability vs. Growth: What Should Your Startup Focus On First?

by Dennis Hammer

In the early days of your startup, you focused on building your product and getting those first few customers. But once you have a small customer base, you'll be faced with a choice:

Do you focus on profitability or growth?

Like every other startup founder, you wish you could have profitability *and* growth, but those concepts are somewhat at odds, especially in the beginning. Choosing one or the other can drastically change the course of your startup.

Today we'll lay out both paths to help you make a decision.

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First, an important caveat: We're discussing whether you'll focus on profitability or growth *for now.* If you choose to focus on growth, you'll obviously switch to a profitability model at some point. And if you choose to focus on profitability, you'll still continue to stimulate growth, but you won't prioritize it.

Focusing on Profitability

"No one ever went broke taking a profit," says Basecamp founder and CEO Jason Fried.

Profitability is obviously important to any business. In fact, your business eventually needs to be profitable in order to survive. Startups may be able to avoid worrying about it in the beginning—while they search for a product/market fit and build a user base—but many choose to monetize their customer base early, using only their profits to fuel growth.

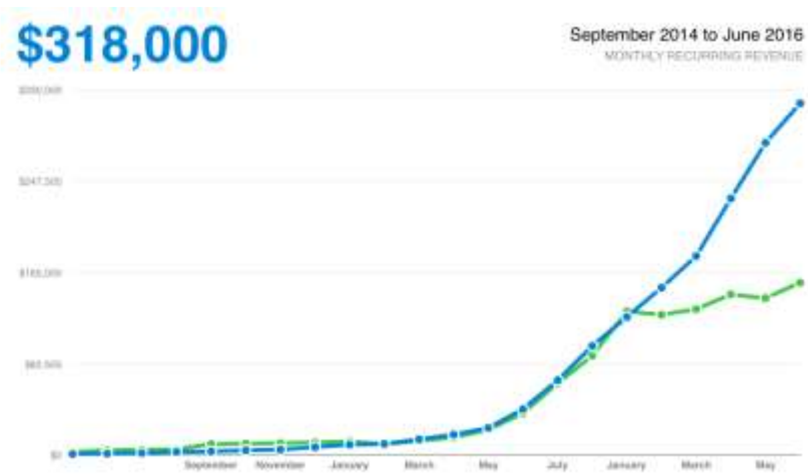
Interestingly, this is how most startups grow: through slow, sustainable, self-funding. We just don't hear about them as much because they don't have sexy origin stories.

Here's what it sounds like: "Things are great. We have 5 customers! We signed a new one on Friday. Our team is now 8 strong and our sales pipeline has interesting deals in it." This is from a CEO who's paying himself and everyone on his team a salary and hasn't taken any investor money.

MailChimp, for example, built a large tech company without taking VC money or spending more than it earned: "No venture capital, no Bay Area presence, no crazy burn rate: MailChimp's founders built the company slowly by anticipating customers' needs and following their instincts...Under the radar, slowly and steadily, and without ever taking a dime in outside funding or spending more than it earned, MailChimp has been building a behemoth. According to Ben Chestnut, MailChimp's co-founder and chief executive, the company recorded $280 million in revenue in 2015 and is on track to top $400 million in 2016. MailChimp has always been profitable, Mr. Chestnut said, though he declined to divulge exact margins. The company — which has repeatedly turned down overtures from venture capitalists and is wholly owned by Mr. Chestnut and his co-founder, Dan Kurzius — now employs about 550 people, and by next year it will be close to 700."

Basecamp and Design Pickle are other well-known startups who focused on profitability instead of growth.

ConvertKit was running out of money because costs were rising as fast as revenue. They focused on profitability by cutting costs, getting efficient, and reducing customer complaints. You can see how revenue (the blue line) eventually pulled away from expenses (the green line).



Seeking profitability early on has three main benefits:

First, you gain precious time. There’s no runway to worry about if you can pay your own bills each month. Obviously you want to avoid non-growth months, but if it happens you don’t need to panic.

Second, investors like to see it. A company that can sustain itself is a safer bet.

Third, you don’t have to rely on investors! You could still take money in the future, but sustaining yourself breaks the reliance on VCs to fund your operation. This gives you lots of options, and some control over the terms of the investment if/when you decide to bring in VCs.

Extracting profit does not always mean finding more customers. There are lots of ways to profit from the users you already have. You might optimize your pricing so customers spend more money with you—or stay on board longer. You might push users to higher-priced plans or upsell/cross-sell products to squeeze more revenue out of each customer.

When should you focus on profitability?

- When you want to control your own destiny.
- When you can’t (or don’t want to) convince investors to fund you.
- When you don’t plan to be a giant company (although MailChimp is plenty big enough with no funding).
- If you serve a high-touch product or service (lots of holding your customers’ hands).

Profitability is the best option for the majority of startups, and Basecamp founder and CEO Jason Fried has learned that it comes with a big benefit:

“When you’re profitable you don’t have to play games, succumb to substitutional metrics, cross your fingers, or grovel for other people’s money, validation, or acceptance. You simply make more money than you spend—and run a fundamentally sound, economics 101 business.”

Focusing on Growth

Focusing on growth means investing everything into growing your customer base—including *other people’s cash* (venture capital). You’re trying to grow your customer base to a critical point before you monetize it. Think about how Uber has taken over most of the world and still loses billions of dollars each year. The actual cash that Uber lost came from their investors.

“Disruptive businesses often require distinct business models,” says Scott Anthony, managing partner of a growth strategy consulting firm. “A push for early profits could lead a company to default to a known model that provides short-term results but stunts experimentation that leads to more long-term value creation.”

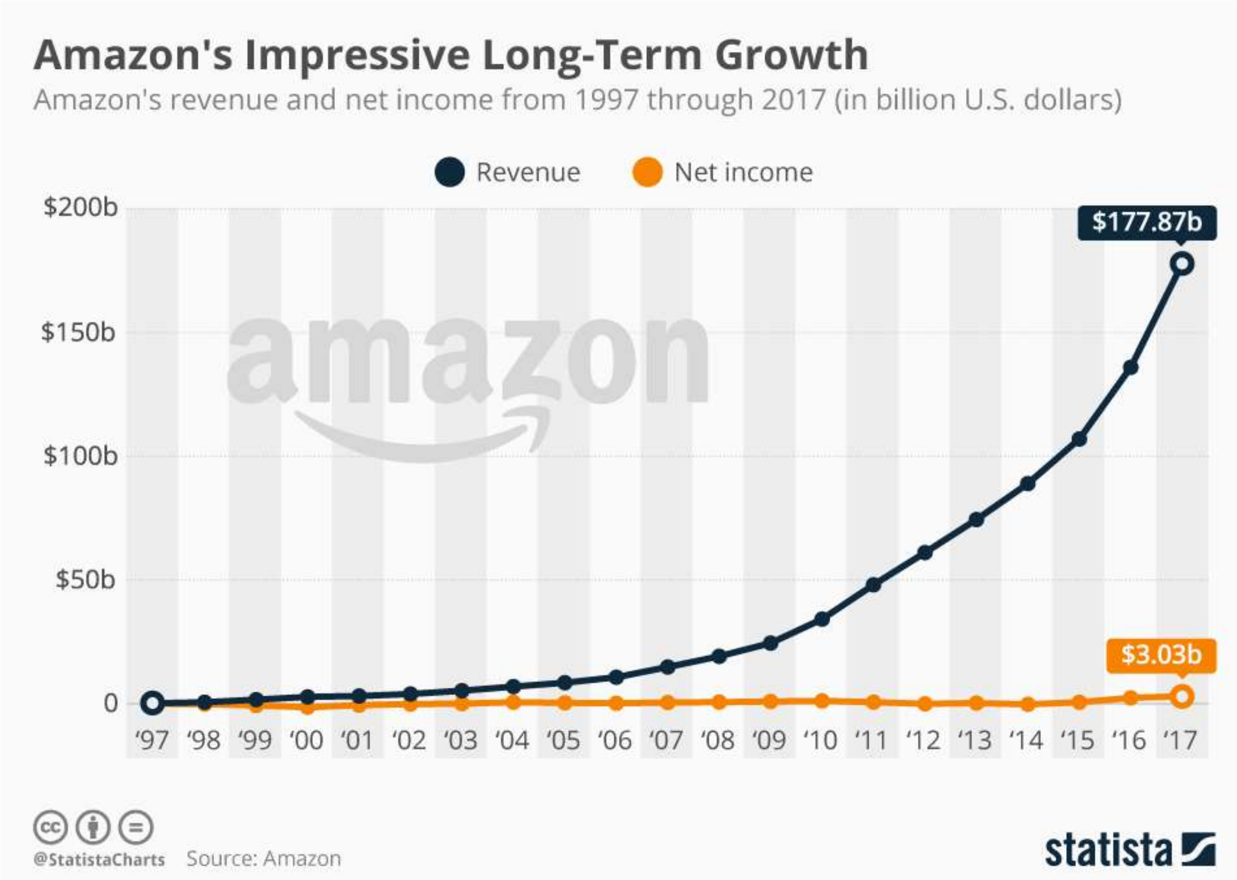
If you have a good idea how you’ll eventually monetize a customer base, it might be smart to invest as much investor cash as possible into growth. You can wait to make money once you have enough customers.

Groupon is one of the fastest companies to reach $1 billion in revenue. Eventually it became the dominant discount deals player, but it spent hundreds of millions of dollars to get there.

Groupon had to grow quickly because its competitors had a low barrier to entry. The technology isn’t hard to build and the model isn’t hard to copy (which hurt them in the long run). It does require an army of sales people to go door-to-door signing up small businesses—which is expensive. If it wanted to control the space, it had to use its first-mover advantage to grow *rapidly.*

Facebook took a similar approach. It put off revenue *for years* for the sake of growing the user base—at enormous cost. They knew they could make money, but they didn’t want to affect the user experience until they had to. So they nurtured their community until they became the ubiquitous social media platform. Only then did they turn on the revenue, and eventually the profitability. Even though they bombard us with ads now, it’s too hard for most people to leave because *everyone’s on it.*

Amazon is a special case. They make a tremendous amount of revenue, but they’re notoriously growth-focused,. So they pour everything back into the company. Their total revenue is climbing steadily, but their profitability remains flat. They can do this because 1) they have massive cash flow and 2) the stock market has rewarded them for this approach so far (even though Wall Street punishes other companies that never make a profit).



If you have product market fit, then taking investor money to focus on growth is the fastest way to build a big company. BUT it comes with one discouraging drawback: It forces you onto a runway. If you don't take off before you run out of money or raise more, your startup fails. Think about if Uber or Facebook had run out of investor money after two years!

If you don't have product market fit, you'll burn through cash with nothing to show for it. Or investors will refuse to fund you. Either way, it's time to a) find product market fit and b) focus on profitability.

When should you focus on growth?

- When you're confident you've found product/market fit.
- When the product/service is easy to scale.
- When you have easy access to capital and investment.
- When you want to dominate the world!

One note of caution: too many entrepreneurs don't have the hockey-stick chart to support their decision to focus on the growth strategy. The reason Peter Thiel invested in Facebook was that they were growing so quickly that their servers kept crashing—making it a no-brainer for him to put money in. Be honest with yourself about whether your startup is seeing the kind of growth that makes investors drool.

If not, you either have some work to do on product market fit or it’s time to focus on profitability.

The Trade-Off Between Profitability and Growth

“In any tech startup there is a healthy tension between profits & growth,” says Mark Suster, startup founder and VC. “To grow faster, businesses need resources today to fund growth that may not come for six months to a year.”

Growth comes with some risk—and you usually have to sell equity to raise the money—but the payoff could be big. Profitability makes you master of your own destiny. It gives you sustainability and leverage over investors, but it could also handicap your growth.

The easiest way to explain the trade-off is with a fictitious example.

Let’s say you have product market fit and you hire four salespeople in January at $120,000 each per year. This means you’re spending $40,000/month on your new sales team, but it might take them six months to start closing deals (complex product, long sales cycle… There are lots of reasons sales might take a while).

In the first quarter of that year, you’ll spend $160,000 more than you would have without the sales team. If you were barely making ends meet before, you might be losing money now.

Of course, once that sales team starts to close deals and grow your customer base, their earnings will eclipse their salaries. But in this example, you had to *sacrifice profitability* to grow, at least in the short-term.

The Middle Ground: Ramen Profitability

Focusing on growth doesn’t mean you make *no* money. If you don’t have investors banging down your door, you have to make at least enough to keep the lights on and your people paid.

Paul Graham calls this “ramen profitable,” meaning you earn just enough to pay the founders’ living expenses so they can keep working without distraction. It’s a healthy balance between growth and profitability.

“Traditional profitability means a big bet is finally paying off,” Paul says, “Whereas the main importance of ramen profitability is that it buys you time.” You’ll usually spend this time finding product market fit.

The beauty of ramen profitability is that you don’t need to raise money to survive. You aren’t at the mercy of investors because you can keep operating, even if you struggle to grow. It’s possible to become ramen profitable just a few months after you launch.

Investors like ramen profitable companies because it shows you can get *someone* to buy from you, and that you're disciplined enough to keep expenses low. You'll still probably seek investment one day—but on your own terms because you won't need it as badly.

Earning enough profit to cover your expenses is also good for morale because employees don't fear the company is going to suddenly shut down one day without warning. The startup feels like a *business.*

What's the Right Strategy for You?

Unfortunately, that question doesn't have an easy answer. Whether you should focus on profitability or growth depends on your business, your customers, and your goals.

The trick is to find the right balance for you. Check out the 10xU community to get advice customized for your situation. Learn more.