The Essential SaaS Metrics

A Guide for Entrepreneurs

1

How SaaS companies are different

Instead of one-time purchases SaaS customers pay every month (or year) to access software or services via the Internet. Ideally, this business model generates a steady and growing stream of revenue, but it can also present challenges that can threaten the survival of a SaaS company.

2

Using metrics to optimize your SaaS business

It's critical for SaaS companies to closely track key metrics as the business grows. Data on customer acquisition, lifetime value and churn rates, among other measures, will guide strategic decisions about what improvements need to be made to the business.

3

Find the financing you need

The characteristics of SaaS businesses can make it difficult for entrepreneurs to get the capital they need. Learning what lenders and other financiers are looking for in a SaaS business will improve your chances of getting financing and growing your company.

What is a SaaS company?

A software as a service company:

- develops an application and makes it available to customers over the Internet
- charges customers a subscription fee to use the application
- manages and updates the software to meet user needs and security requirements

3 differences of the SaaS business model

1 Recurring revenue

Instead of a one-time purchase, SaaS customers pay over a period of time—a monthly or annual fee to use an application. The goal for a SaaS business is to create a growing stream of recurring revenue by attracting new customers and limiting cancellations.

2 Scalability

Because it's digital and delivered over the Internet, a SaaS product can be sold to an unlimited number of users with only small increments to cost of goods sold. For SaaS businesses, key expenses are for R&D, and sales and marketing to acquire and keep customers.

3 Comparable metrics

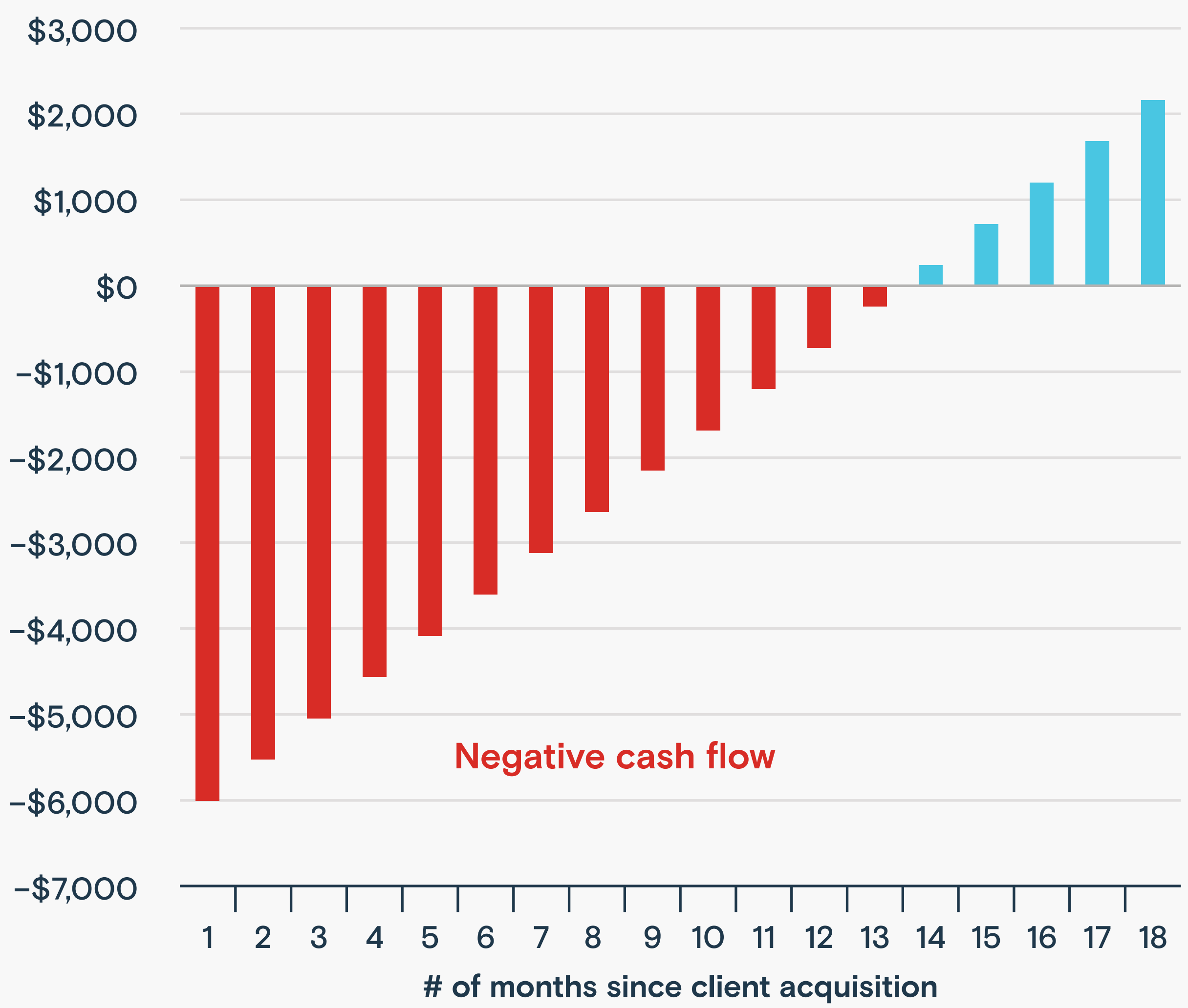
SaaS businesses have similar characteristics and generate the same types of data. This makes them highly comparable, allowing entrepreneurs, lenders and investors to quickly understand a business and benchmark its performance against others.

Why SaaS companies typically lose money in the early stage[1]

In the early stages, SaaS companies lose money because they must spend on R&D, and sales and marketing. The business then makes the money back as customers pay subscription fees over subsequent months (or years). The company generates negative cash flow until it turns the corner and becomes profitable.

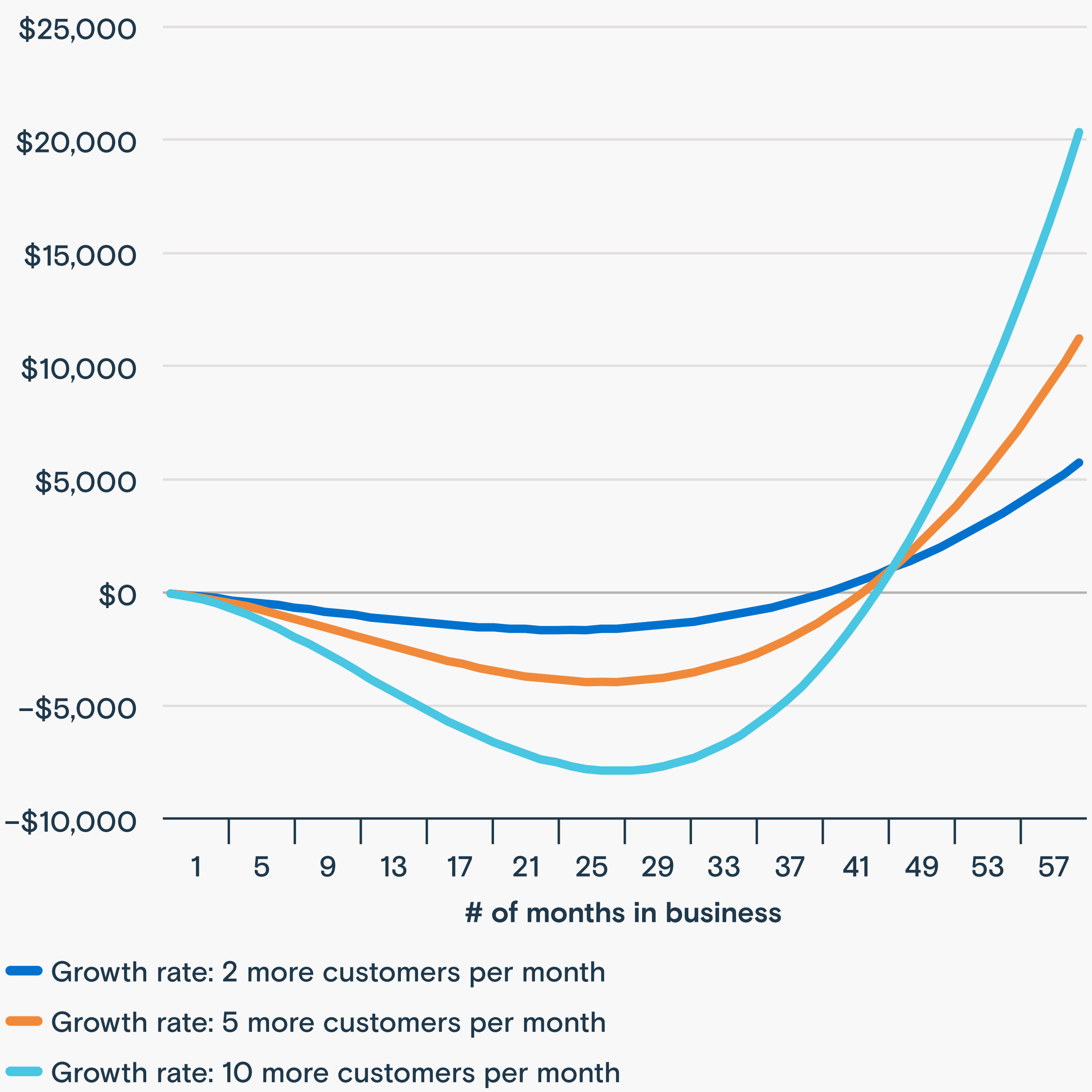
The period of unprofitability typically lasts 12 to 36 months. This can be challenging for entrepreneurs and investors because money must be invested to bring on new customers with the faith that these investments will pay off down the road.

Single customer cumulative cash flow



1. Source for figures on pages 4, 5 and 11: For Entrepreneurs from David Skok "SaaS Metrics 2.0—A Guide to Measuring and Improving What Matters." Accessed June 29, 2021. https://www.forentrepreneurs.com/saas-metrics-2/

Impact of faster growth on profit and loss/cash flow

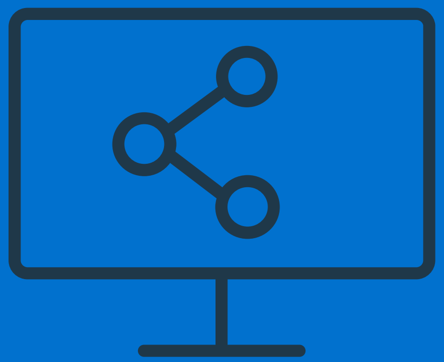


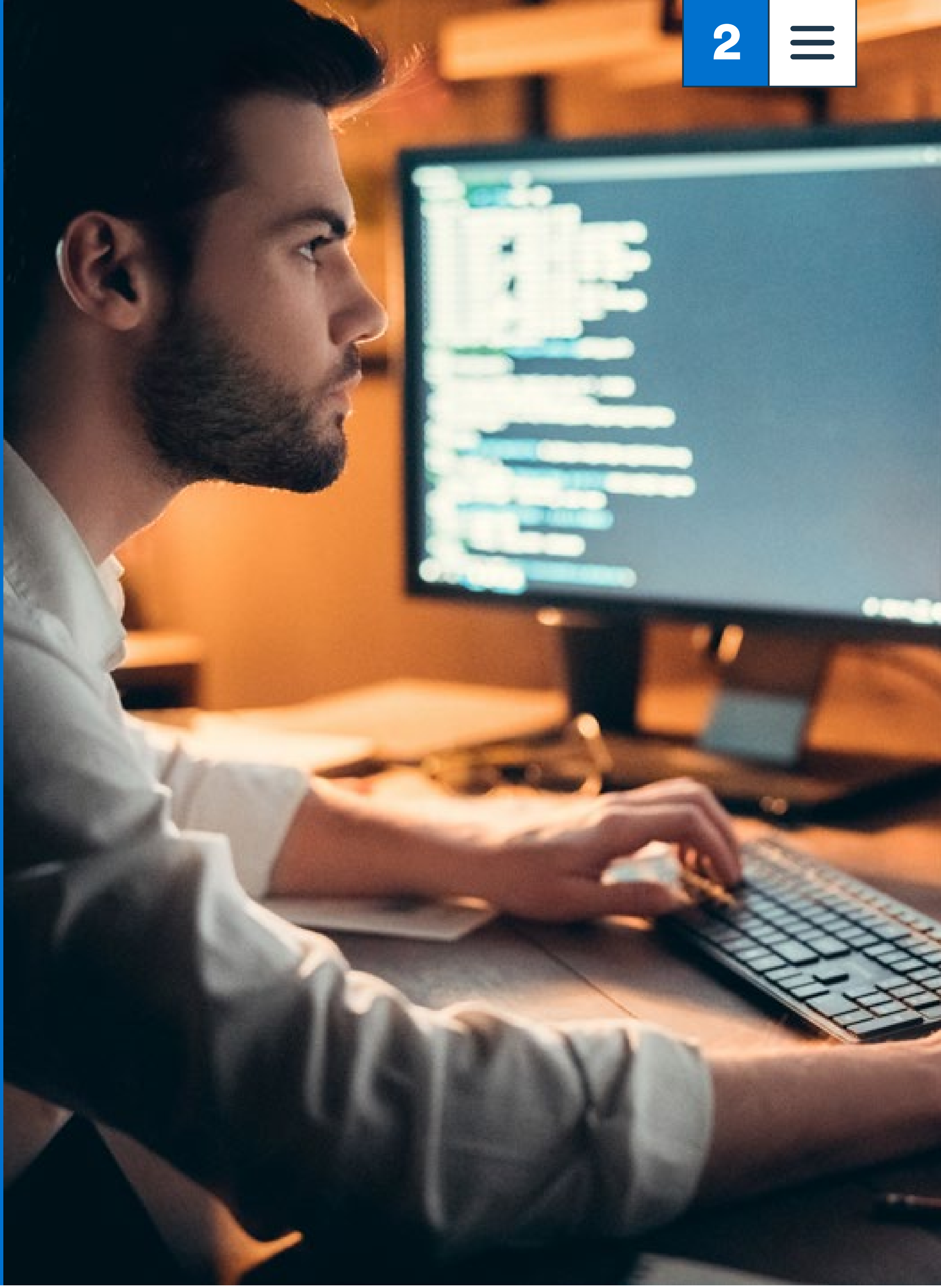
Higher growth = higher losses in the early days

The more a SaaS business spends to grow its customer base in the early days, the deeper its losses will be. However, if the business is successful in finding and retaining customers, it will eventually be rewarded with a higher rate of growth.

4 metrics to make sense of it all

Metrics allow entrepreneurs, investors and lenders to see how a company is progressing over time. For SaaS businesses, key performance metrics indicate whether a company is meeting its growth targets and where improvements are needed.





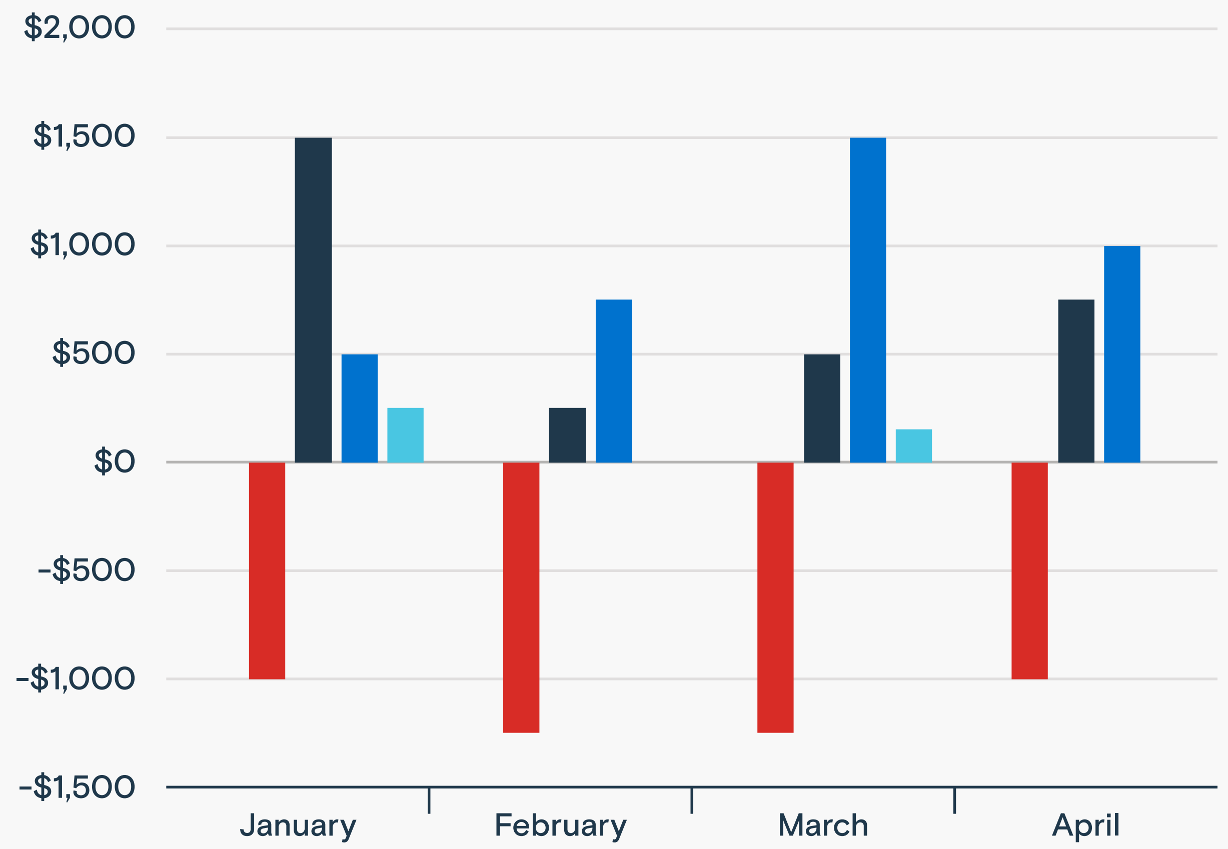
1 Recurring revenue

Recurring revenue is a fundamental measure of how a SaaS business is doing in terms of attracting and retaining customers in a given period—monthly (MRR), quarterly (QRR) or annually (ARR). Tracking recurring revenue allows you to understand how fast the business is growing as well as how much cash is coming in.

$$\text{Recurring revenue} = \frac{\text{Subscription revenue owed during a time period}}{\text{Amount of elapsed time}}$$

Breaking out different sources of new and lost revenue will help you analyze the business and make improvements.

Monthly recuring revenue



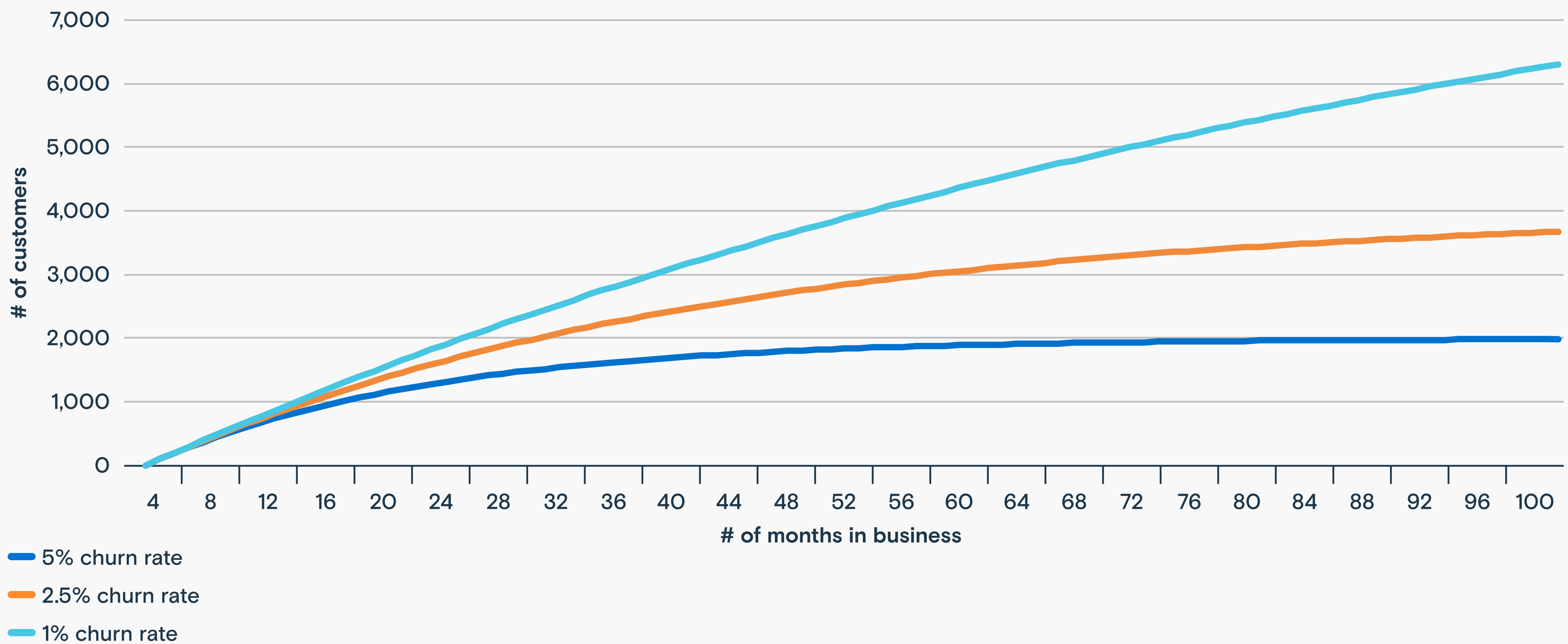
- Churn—Customers cancelling their subscription.
- New business—Leads converting to new subscriptions.
- Expansion—Growth from existing customers who upgraded their service.
- Reactivation—Previous customers reactivating their accounts.

② Churn rate

The churn rate reflects the number of customers who cancel their subscription over a given period of time. It's an important metric for understanding the stickiness of your product.
As a business scales up, a high churn rate will increasingly limit its growth potential. A 10% churn rate for 500 customers is only 50 customers, but for 5,000, it's 500 customers whose revenue must be replaced.

$$\text{Churn rate} = \frac{\text{Customer cancellations in a period}}{\text{Total customers at start of period}} \times 100$$

A high churn rate will quickly stop your growth



Revenue churn rate

An equally important metric to track is your revenue churn rate. This helps you understand how much recurring revenue (RR) your business has lost due to customer downgrades or cancellations in a given period.

$$\text{Revenue churn rate} = \frac{\text{RR lost in a period}}{\text{Total RR at start of period}} \times 100$$

Net revenue retention rate

Bringing it all together is the net revenue retention rate. It gives a comprehensive view of positive and negative changes to existing customer interactions with your company. It is the percentage of recurring revenue that's retained from existing customers over a period of time, including revenue gained from expansion or reactivation activity offset by revenue lost through subscription downgrades and cancellations.

$$\text{Net revenue retention rate} = \frac{\text{Gross RR churn} - \text{Revenue gained from expansion and reactivation}}{\text{Total RR at start of period}} \times 100$$

Negative recurring revenue churn is the holy grail of SaaS businesses. It occurs when additional revenue earned from existing customers through subscription expansion and reactivation exceeds revenue lost to customer churn. Negative revenue retention churn leads to accelerating growth for a SaaS business.

3 Customer acquisition cost (CAC)

CAC is the total cost of all marketing and sales activities required to find a customer and convert them into a paying subscriber. Used with another metric, the lifetime value (LTV) of a typical customer, CAC allows your SaaS business to understand whether it's earning more from customers than it costs to acquire them. CAC is an essential metric for determining whether your SaaS business is viable and for making strategic decisions about how to improve it.

$$\text{CAC} = \frac{\text{Sum of all sales and marketing expenses}}{\text{Number of new customers added}}$$

What to include in CAC

You should include every expense related to customer acquisition, including salaries, website, marketing tools, advertising, office space and other physical infrastructure for the sales and marketing teams. Once set, your method for calculating CAC should remain the same to allow for tracking performance over time.

4 Customer lifetime value (LTV)

LTV is the amount of profit you earn from a typical customer over the course of their relationship with you. The longer customers are loyal to your app, the greater your LTV. It is important because SaaS companies spend money to acquire customers then recoup it over the time they are subscribed to the service. Your LTV is directly related to your churn rate and will affect how much you can spend to acquire new customers.

$$\text{LTV} = \frac{\text{Average revenue per account (ARPA)} \times \text{\% gross margin}}{\text{Revenue churn rate}}$$

How to increase LTV

Lifetime customer value can be increased through earning more from customers through upgrades and add-ons (account expansion for higher ARPA), reducing expenses (higher gross margin) or lowering the churn rate (customers pay you for a longer time).

2 key ratios every SaaS company should track

LTV/CAC ratio

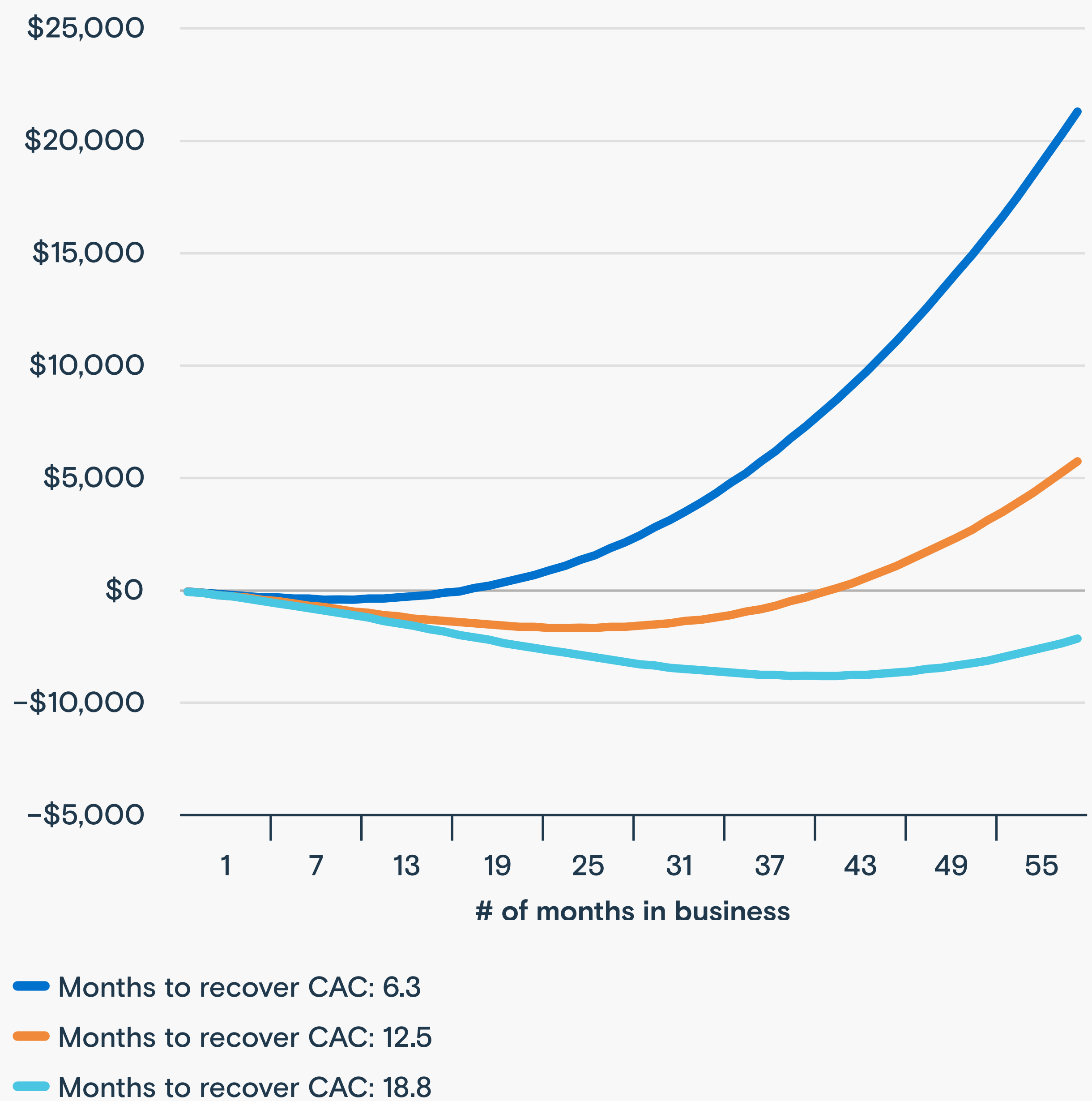
This ratio compares the value of a new customer over its lifetime to the cost of acquiring that customer. An LTV to CAC ratio that is less than one generally indicates customer lifetime value is not compensating for the cost of acquiring new customers. Rule of thumb is that you should aim for a LTV/CAC ratio greater than three.

Months to recover customer acquisition costs

This ratio indicates how long it takes for a SaaS company to reach positive cash flow and profitability. To be successful, a company will generally need to recover customer acquisition costs within a year. While the best companies recover CAC in five to seven months, the period typically goes beyond a year for start-ups. Months to recover CAC is an indicator of the effectiveness and sustainability of a company's strategies to attract new customers.

$$\text{Months to recover CAC} = \frac{\text{CAC}}{\text{ARPA} \times \text{Gross margin}}$$

Impact of 'months to recover CAC' on cash flow



6 tips to reduce churn

It takes a lot of hard work and money to acquire SaaS customers. If they only stick around for a month or two, all that effort is for naught, and your business is headed for trouble. Even small improvements in your churn rate will produce important gains in customer lifetime value. That's why your business needs to pursue a disciplined, methodical customer retention strategy. The payoff will be a faster growing, more profitable business.

1 Make your product indispensable

As all SaaS founders know, product-market fit is the key to a sticky product. But finding fit is not a onetime event. It's an ongoing, iterative process of creating and refining a product that fulfills real customer needs and does it better than the alternatives. That means not only developing the features customers want and need, but also making sure your sales and marketing efforts are targeting the right customers.

2 Monitor churn data

It's essential to continuously track your churn metrics so you can evaluate how the company is doing. This data should be part of a performance dashboard that includes other key performance indicators. A dashboard allows you to set targets and get your team involved in suggesting and implementing projects to improve churn and other aspects of the business. Dig deeper into the data to analyze churn by customer revenue segments and/or cohorts to identify common characteristics of subscribers who are cancelling.

3 Do a good job onboarding

Your goal is to build a strong relationship with customers from the moment they discover you through to becoming a loyal, long-term subscriber. It all begins with good onboarding, including a simple, easy sign-up process, a welcome email, a first login message, a product tour and user tutorials. Your onboarding should help customers understand how to use your product and get full value from it.

4 Nurture customer engagement

Customer inactivity leads to cancellations. So, use content such as an email newsletter, blogs, webinars and eBooks to lead users back to your product or service and build their engagement with your brand. You can also encourage loyalty by celebrating customer success stories and featuring testimonials on your website, social media feeds and in your content. Another good engagement strategy is to make special offers to customers and upsell them to higher-priced services or add-ons.

5 Listen to customers

Obviously, you should have a friendly, knowledgeable and helpful customer support team. But you should also proactively reach out to customers to ask about their experience with your service and offer help in using it. Make sure you have a formal process for collecting information about problems, complaints and cancellations. You might not be able to solve every issue or add every desired feature to your product, but you can identify trends that demand attention.

6 Reduce involuntary churn

Involuntary churn occurs when a customer's payment fails because their credit card has expired, lacks funds or the payment is not received for some other reason. This can represent a surprisingly large share of total revenue churn. SaaS companies use several techniques to recover delinquent payments and retain customers including retrying credit cards and contacting customers by email and/or in-app messages.

Can my SaaS company get a business loan?

The founders of SaaS companies are often focused on attracting venture or angel investments. While this is the right route for many businesses, your company should also consider getting a loan or credit line. Debt financing has the advantage of allowing you to maintain control over your business while avoiding ownership dilution. To get a business loan, you will need to find a lender with expertise in the special dynamics of SaaS businesses and present them with a clear picture of your company's current situation.

3 questions to answer before applying for a business loan or line of credit

How much runway do we currently have?

You most likely will be borrowing money to extend your runway as you increase your recurring revenue and get over the losses at the early stages. Lenders will naturally want to know how much runway you currently have; how much of a runway extension you are seeking with your loan request; and get realistic cash flow projections for your business.

Cash burn and runway

Cash burn measures how much money an unprofitable company is "burning" in a month.

Monthly net cash burn = Total revenue − Total operating expenses

By dividing cash on hand by monthly net cash burn, a company can calculate its financial runway—the number of months it can operate before it runs out of money (if no operational changes are made or no new cash is injected into the company). This is a key measure for start-ups that have not yet reached profitability. A good rule of thumb is that a company should have at least six to 12 months of runway.

What is your business worth?

Before meeting a lender, make a conservative calculation of how much your company is worth based on your annual recurring revenue. SaaS companies have been soaring in value in recent years with buyers willing to pay six to 12 times ARR, even for companies not currently turning a profit. An experienced lender will evaluate your business model, current recurring revenue and potential growth to decide whether to provide you with a loan. They might even be able to help you find the right positioning for your business and put you in contact with business partners who can help accelerate your growth.

How do our costs break down?

Because many SaaS companies are losing money, bankers look to see how their expenses break down between operations, R&D and marketing. Would your company be profitable if you were only paying current operational costs? Often, the answer is yes. SaaS companies are losing money because they're investing to develop their product and grow their customer base. If you could turn a profit by theoretically cutting these costs, this means your business is valuable and your company can get a loan or line of credit.

> **“To get a business loan, you will need to find a lender with expertise in the special dynamics of SaaS businesses and present them with a clear picture of your company's current situation.”**

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