vcfo
Making Companies Stronger™

WHITEPAPER

SOFTWARE AS A SERVICE

Key Performance Indicators for Founders & Practitioners

How SaaS Differs From the Traditional Software License Model

Software license model – The customer obtains rights to use the software on its servers and computers. Software licensing is generally treated for financial reporting purposes as a delivery and sale of a product.

SaaS model – The customer buys a hosted service based on proprietary software, but does not receive a copy of the software to use on its own. SaaS is treated as the sale of a service that is provided over a contract term.

Why Choose SaaS?

- Elimination of upfront capital equipment purchases
- License fees paid on an as-needed basis
- Rapid deployment
- Measurable ROI
- Access to the most current releases in real-time
- Offloading responsibility for up time
- Back-ups are very attractive game-changing features

As tighter capital budgets demand leaner alternatives, it is no surprise that SaaS adoption continues to rise within the enterprise application markets. Currently, more than half of CFOs at leading U.S. technology businesses are using cloud computing in some capacity, according to the BDO Technology Outlook Survey. More than 95 percent of organizations plan to increase their use of SaaS, according to Gartner. In the survey, CFOs cite cost flexibility (32%), increased scalability (32%) and improved business ability (29%) as the driving reasons for embracing cloud computing.

Five Must Have KPIs for SaaS Companies

SaaS metrics are not regulated, but should be governed by best demonstrated practices. Identifying the most relevant Key Performance Indicators (KPIs) helps companies outperform their peers.

Because successful SaaS companies often experience hyper-growth as they reach scale, it is important to implement the necessary systems and best practices early in the life of the company in order to properly report financial results in accordance with GAAP (generally accepted accounting principles) and to report on KPIs regularly to allow management to execute on the strategic and operational plans effectively.

SaaS executives must consider the most important KPIs for tracking their own business. Based on vcfo's extensive experience working with multiple SaaS businesses through all phases of development, go-to-market strategies and growing to scale, our recommendation is to track the following essential KPIs. Developing and tracking metrics specific to the SaaS realm will result in improved performance and transparency, and provide a measurable road map to growth and success.

1: CMRR, including MRR and ARRR

Committed Monthly Recurring Revenue (CMRR), Monthly Recurring Revenue (MRR) and Annual Run Rate Revenue (ARRR)

CMRR is the primary KPI to track. It provides a better picture of the health of a SaaS business than MRR and ARRR. The revenue actually committed under contract gives a solid view of the base revenue, based on customer commitment.

Many companies rely on total contract value (TCV) and/or annual contract value (ACV or bookings). These metrics are flawed for many reasons, most notably with regard to the uncertainty of duration and services. For very dynamic private companies, they can be highly misleading.

2: Cash Flow

Early stage companies should start with gross burn rate and net burn rate, or cash flow which is the net of cash inflows and outflows in a given period. Over time, these will hopefully turn to positive free cash flow which is the cash that a company is able to generate after laying out the money required to maintain or expand its asset base. CMRR provides a clear sense of the revenue health of the business, but without line of sight to the collections of the revenue, it is disconnected from the "cash health" of the business.

Gross and net burn rate metrics are critical for SaaS businesses because the capital requirements are dependent on competitive pressure and revenue growth goals. Net burn rate is simply all cash received during the month, minus all expenses paid, which nets out to the cash burned in the month.

These numbers are choppy due to the timing of collections and payables, so most companies refine this by adding a "rolling three month average" burn rate set of metrics.

3: CAC and months to repay CAC

Customer Acquisition Cost (CAC) and CAC Payback Period

CAC is the cost associated with converting a prospect or trial customer to a paying customer. This cost includes the product cost as well as the cost involved in sales, marketing and other acquisition costs. This is a key business metric.

$$CAC = \frac{\text{Sum of all Sales \& Marketing Expenses}}{\text{Number of New Customers Added}}$$

The CAC payback is a metric, stated in months, of the time to fully pay back sales and marketing investment for new customer acquisition.

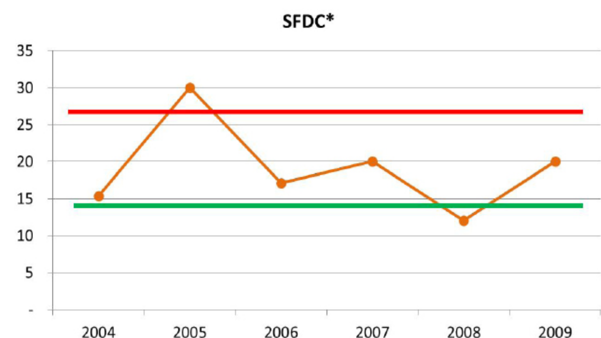
$$\text{Months to Recover CAC} = \frac{CAC}{\text{Avg. MRR per Customer} \times \text{Gross Margin \%}}$$

If the months to repay CAC are below or close to 12, SaaS companies should invest more aggressively and accelerate growth if capital is available. If this is not the case, companies should not optimize the sales and marketing spend to stay at cash flow break-even.

If the months to repay CAC exceed 24 months, it is time to put on the brakes and focus on sales funnel productivity metrics. Funnel velocity may be impaired by unproductive marketing campaigns or a flawed sales process.

If the ratio is between 24 and 12 months, SaaS companies should keep the same level of sales and marketing investment – or reduce it based on the capital available – and focus on productivity improvement.

** SalesForce.com Historical CAC*



4: CLTV

Customer Lifetime Value

CLTV is the recurring profit streams of a given customer less the acquisition cost, discounted to net present value (NPV). The beauty and financeability of the SaaS business model is that once customer acquisition costs (CAC) are retired, the cash flow and profit streams from customers can be quite attractive.

5: Churn & Renewal Rates

Including Logo Churn, CMRR Churn and CMRR Renewed

For the SaaS industry, the general notion is that companies spend five to seven times more in acquiring customers than the amount they spend on retaining existing customers. Customer acquisition is generally easy, but after that comes the problem of keeping those customers. In a hyper-growth environment, SaaS executives often miss the mark by spending most of their resources and attention on growth through new customers while failing to keep the existing customers happy.

In other words, the companies are not taking measures to keep their churn rate at a minimum. When SaaS companies fail to pay attention to existing customers and only focus on obtaining new ones, a hole develops in the business boat. Sooner or later, if the focus remains on customer acquisition as opposed to customer retainment, the boat will sink.

The top performing cloud companies can enjoy annual logo churn rates below 7% and CMRR churn rates below 5%. Many times, this rate is due to death (bankruptcies) or marriage (acquisitions), and CMRR churn can be offset by upsells into the installed base.

The Future for SaaS Companies

For SaaS companies, the future is bright. Yet in order to succeed, these types of companies need to abide by accounting principles and understand the KPIs that will guide them toward success, or turn to trusted partners for help.

About vcfo

vcfo makes companies stronger through finance, HR, technology and recruiting support, enabling business leaders to focus on driving objectives and growth plans. We're more than just a financial consulting firm. We provide expert guidance and assistance with a suite of services across the operational spectrum.

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Founded in 1996, vcfo's original core offering was fractional or part-time CFO solutions. The company's services have long since evolved to include an integrated suite of finance, HR, technology and recruiting support, including outsourcing and consulting solutions that improve operational performance and optimize productivity.

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