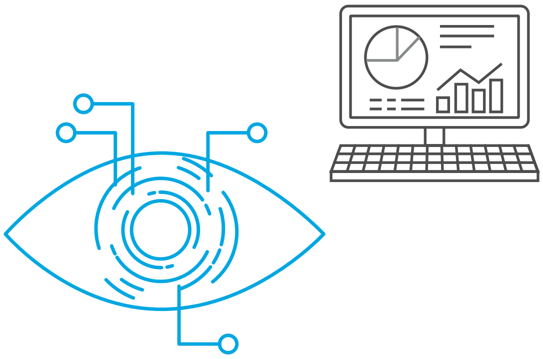
KEY METRICS IN SAAS
– *And Why They Matter!*



Various key metrics are used in subscription-model businesses like SaaS, such as ARR (Annual Recurring Revenue), MRR (Monthly Recurring Revenue), and the Rule of 40.

Here's an overview of these metrics, and why they are important.

What are ARR and MRR?

ARR is an annual revenue metric. It refers to the value of a subscription business's recurring revenue, normalised for one year. For a SAAS business it is arguably the most important metric as it leads directly to the valuation of the company. One of the most common ways to value a SAAS business is as a multiple of ARR.

MRR is a monthly metric and is used to derive ARR. It equals the number of subscribers per month multiplied by the ARPU (Average Revenue per User).

In the tech industry, deriving ARR as a multiple of MRR tends to be the preferred model. It involves additional customers coming on board over the year, which can impact on revenue exponentially. A fast growing business will add new customers each month and if they retain them this leads to growth in ARR.

In a business that offers, say, three-year subscriptions, ARR would be equal to subscription revenue divided by three. You would then divide this by 12 to understand the impact on MRR. It is critical to work multi year or month sales back to the correct monthly figure – this avoid inflating the ARR and therefore anticipated valuation multiples.

When MRR is measured in the last month of a subscription model, it enables you to forecast revenue for the NTM (next 12 months), with a reasonable degree of accuracy.

How to calculate MRR and ARR

Here are some examples:

- Month 1: 100 users at $99 per month = MRR of $9,900, and ARR (MRR x 12) of $118,800.
- Month 2: 110 users at $99 per month = MRR of $10,900. Now ARR has increased to $130,680 (NTM).

Note: when calculating these metrics, it's assumed that once a customer subscribes, they will be retained. Dealing with loss of customer or churn is critical to the valuation of technology companies. See the RSM article on Customer Churn: What it is and How it Affects Tech Companies.

MRR also comprises other components on top of new customer revenues.

– Expansion MRR:

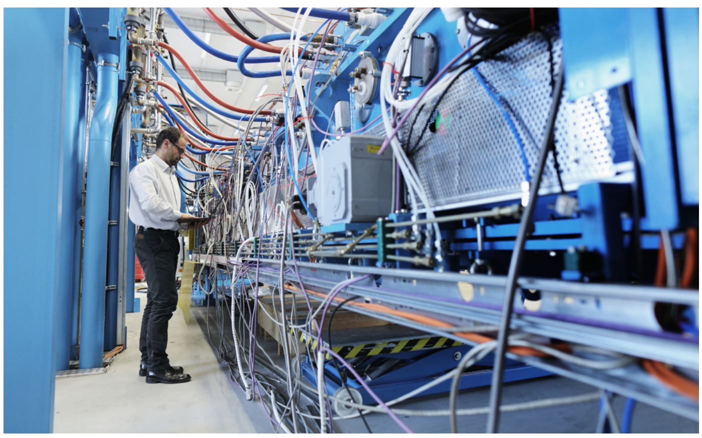
Expansion MRR refers to additional revenue gained from existing customers through add-ons or additional sales, such as plan upgrades in a tiered subscription model. This metric is important as it gives an indication of customer loyalty level. It also creates higher margins as the cost of acquiring new customers is absent.

Expansion Revenue enables increased customer account values, with greater retention leading to increased profitability and more sustainable cashflows. This means companies that are highly focused on new customer acquisition should run both customer retention and expansion strategies.

Getting more revenue from existing customers leads to lower or no customer acquisition costs.

Expansion MRR percentage growth rate is measured as below:

- (New Revenue from Existing Customers) / (Total MRR Last Month) x 100.



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– Contraction MRR:

As the name suggests, this is the reverse of Expansion MRR. It refers to revenue loss due to churn (subscription cancellation) and subscription downgrades. There can be the temptation to reduce CSM ("Customer Success Manager") costs in a small tech company, however this is a key position that leads to the creation of loyal repeat customers. Measuring Contraction MRR is a great way to understand if the investment in CSM is adequate.

Contraction MRR becomes more important as businesses mature, where customer acquisition costs increase and it become increasing difficult to find new customers. Often success is measured by retaining clients.

– Net New MRR:

This metric measures growth in MRR from one month to the next as follows:

- New MRR + Expansion MRR – Contraction MRR.

This measure shows how successful we are overall in growing revenue. The key components add to show how successful we have been in enrolling new clients, expanding revenue from existing and retaining them.

Why ARR and MRR matter

These metrics are crucial in SaaS businesses for several reasons, including:

- Measuring momentum: these metrics can be useful for measuring shifts and changes in not only new sales but also upgrades, renewals, downgrades and cancellations.
- Revenue forecasting: ARR enables better forecasting of future revenue and new growth. For example, when you track the value and pattern of new and cancelled subscriptions, you will be in a better position to predict NTM revenue.
- Better decision making: ARR can be useful for detecting where revenue is being gained or lost, which in turn informs business decisions.
- Company valuation: ARR is a key determinant when it comes to valuations especially as the revenue model is what drives the success of a tech company.
- The components of ARR can be broken down to help in understand the success of resource allocation, particularly between customer acquisition and nurturing.
- Attracting investment: potential investors look for predictability of revenue when making decisions, which subscription-model businesses can offer over one-time sale companies. ARR can be used to show investors the company's revenue stability.

The Rule of 40 metric

The Rule of 40 is another important metric in the tech industry.

This metric says that the company's revenue growth rate plus its profit margin (or EBITDA) should be equal to at least 40%.

So, let's say your EBITDA is 15% and your growth rate is 25% – in this case you would meet the Rule of 40.

The two percentages may differ widely from each other though, as there is always a trade-off between profitability and growth. For example, if a company is heavily focused on revenue growth and spending a lot on marketing, its profit margin is likely to be lower than its growth. But the important thing here is that the two percentages add up to at least 40%.

There are also variations of the Rule of 40, such as the Weighted Rule, which places twice the weighting on revenue growth than it does on profitability.

Why the Rule of 40 is important

- It can be useful when comparing SaaS companies.
- It is a normalising factor in that there are many ways to achieve the 40% result.
- The Rule is important when seeking funding, as investors will often use it to gauge the health of SaaS companies.
- In smaller SaaS businesses, the Weighted Rule of 40 may be particularly important for attracting investment. This is because investors tend to favour growth over profitability, especially in smaller companies.

How we can help

RSM Australia is a FinTech Gold Partner. Our services include advisory and detailed financial modelling for technology companies that are seeking revenue growth.

This starts out with a free consultation to see if we are a good match for your company. [Get in touch] to book a call!