CUSTOMERS

– *What are they worth, and what do they cost?*

To create sustainable capital value in your business, you need to ensure you are not spending too much on acquiring new customers.

By "too much" we mean more than the value they bring to your business.

This is why it's so important to regularly assess your Customer Acquisition Cost (CAC) and compare it to your Customer Lifetime Value (CLV).

How to measure CAC

CAC consists of all the expenses incurred in acquiring new customers – such as advertising, marketing, sales staff salaries and other costs. This can often add up to a substantial amount. So unless your revenue from new subscribers is substantially more than your CAC, you'll most likely be leaking money!

The formula for CAC is: Acquisition Spend/Total Number of New Customers Acquired.

So let's say you spend $10,000 and acquire 500 new subscribers – your CAC would be $20.

CAC closely relates to the profitability of a business, particularly if it is EBITDA-negative and growing its market share.

But what do these numbers mean in context? That's where CLV comes in.

Measuring CLV

CLV (also sometimes referred to as LTV or CLTV) is the average gross profit from a typical customer over the life of their relationship with the company. At a simplified level, CLV is measured by adding up the revenue earned from a typical customer and deducting what it cost you to acquire them.

An effective way to calculate CLV is:

ARPU (Average Revenue Per User) x Average Gross Margin x Average Customer Lifespan in Months, less CAC.

So if ARPU was $100, gross margin 50%, average lifespan 6 months and CAC was $30, we would end up with a CLV of $270.

A healthy CLV usually indicates you can afford to spend more on acquiring customers than otherwise.

Comparing CAC to CLV

The important metric here is your CLV/CAC ratio. At a minimum, your CLV should be 5 times greater than your CAC.

Example:

In a case where a customer generates $100 per month in gross profit as a subscription and has an average stay of 6 months, they would be worth $600 to your company. Therefore you should spend no more than one-fifth ($120) to acquire them.

A higher ratio than 5:1 is better of course, and it will improve your ability to scale up. A lower ratio may mean you need to focus more on retaining existing customers or reducing churn to improve profitability.

Your customer acquisition payback period

Another useful metric is to work out how long it takes to recoup the money you spend on acquiring customers.

This can be calculated by dividing CAC by gross margin earnings. One way to do this is: CAC / MRR (Monthly Recurring Revenue) x recurring gross margin %.

So let's say it costs you $400 to acquire a new customer on a $100 per month subscription with a profit margin of 50%.

The formula would be: $400 / $100 * 50% = 8 months.

However, your churn rate also comes into play here. This is because if your payback period is 8 months, but your subscribers are dropping out at 4 months, you will need to look at ways to encourage your customers to stick around.

Tips for improving your CLV/CAC ratio

There are plenty of actions you can take to reduce your CAC and improve your CLV/CAC ratio. Which ones you take up will depend on your situation. Here are some ideas:

- Refine your marketing and reduce your spend – e.g. create buyer personas and employ more targeted ads or marketing approaches, and/or make more use of lower cost alternatives such as social media or email marketing.
- Analyse your marketing to assess which campaigns and channels are getting the best results – such as A/B testing of landing pages.
- Offer free trials to new subscribers – while bearing in mind that many people may not switch to a paid option.
- Make it easier for people to subscribe – e.g. fewer fields to fill in, easier payment systems.
- Improve your product market fit – i.e. in terms of how valuable your customers see your product.
- Automate some of your customer acquisition activities to help reduce employment costs.
- Increase your subscription fees to improve revenue.
- Improve your customer retention.

The value of customer retention

A little while back, we produced an article on customer churn and explained how SaaS companies often place a high degree of emphasis on acquiring more subscribers. However, while this can be fine for a brand new business, a more mature and established company should shift its emphasis onto retaining customers.

Customer retention is extremely valuable. In fact, research indicates that a 5% improvement in retention can lead to a profitability increase of at least 25%. Retaining customers is also less costly than acquiring new ones, and reducing customer churn can help improve your CLV/CAC ratio.

A couple of ways to improve customer retention and in turn your CLV/CAC ratio include offering upsells (e.g. such as a tiered plan for businesses as they grow) and creating loyalty programs. And while there are no guarantees, you may also want to focus on acquiring those customers that appear more likely to stay with you.

How we can help

Creating a profitable SaaS model is often a balancing act between how much you should spend to win a new customer in relation to the revenue stream they will bring to your business over their lifespan with you.

If you need assistance in this, feel free to speak to us at RSM. Our services include advice and financial modelling for SaaS companies that need assistance in reducing acquisition costs and creating sustainable subscription models. We are also a FinTech Gold Partner.

But in any case, we always begin with a meeting to determine whether we will be a good match for you. Get in touch to book a call!