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Sorting your Models from their SaaS and their CAC(k)

SaaS, or Software as a Service appears to be the new exciting kid on the block, quite often speaking a completely foreign language. Who is this kid… and what is ARPU, CAC and CMR?

Here at Clare Capital we have been doing financial modelling for several New Zealand SaaS companies (both public and private), during which, we have had a bit of a crash course in the world that is SaaS and would like to pass on some of what we have learnt.

[For those that live and breathe SaaS, feel free to point out anything we misrepresent, for everyone else feel free to contact us for more information].

Firstly, SaaS? What?

The source of all knowledge, Wikipedia, tells us that SaaS stands for Software as a Service and is "…a software licensing and delivery model in which software is licensed on a subscription basis and is centrally hosted on the cloud by independent software vendors…"

Again for those in the know, this is perhaps helpful, but for others perhaps not.

How Clare Capital has come to think about SaaS:

SaaS is a market delivery mechanism and a product.

It is the sale of software that has day to day business applications, think invoicing, payroll, HR software. This isn't the new or exciting component. What is new is that instead of purchasing this software on a license with a significant up-front cost and on-going maintenance fee, the SaaS approach delivers the product to the market via a recurring, often monthly fee – the market delivery mechanism. This approach is attractive to users of the software due to lower initial setup costs. Another key feature is that SaaS software is often priced on usage levels, meaning that scaled down products or reduced volume products can be offered to users. This opens the product up to a potentially wider market. Also subscription based sales favours internet sales and as such the SaaS business model has a very different sales strategy compared to non-SaaS business models and has the benefit of being scalable outside of local markets.

As a product, SaaS differs in that the software is centrally hosted away from the individual users, benefiting from economies of scale in terms of: data storage and processing grunt, software development expertise and customer support. Essentially rather than having software and data storage spread-out amongst the individual users of the product, the point of execution for this has moved back with the developers of the software. Put it another way the concept is, rather than being sold software to use and run (with a helpline), the user is subscribing to a product whose up-keep remains the responsibility of those who developed it.

What does a SaaS company look like?

Given that the product is software, there is a strong bias towards SaaS companies being software companies from the get go, no surprise there. However, SaaS is a delivery mechanism for a product, so companies that can take advantage

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of their product being software, can also become SaaS companies. Either way the product is a centrally supported software solution, so expect a company with a lot Information Technology (IT) expertise. Quite often the people involved are very passionate entrepreneurs who either explicitly or implicitly subscribe to Clayton Christensen's theories of Innovative Disruption (discussed in subsequent posts).

SaaS companies make a loss (well at least a lot of them do in the near term). And this makes the news – a lot. One of the key features of the SaaS business model is it's scalability outside of local markets through its delivery via the internet and its scalability in terms of the scaled up, or down, product offering. It is this potential that the SaaS business model attempts to tap into. Developing the products and acquiring the customers' costs money. But with low levels of churn (discussed further below), once acquired these customers provide a stable recurring revenue stream.

Making a loss in the short term is okay as long as it is adding value in the long run. What does this grand statement mean in practise? It is okay losing money in the near-term as long as the money you lose in-turn generates more in the future (at a level to compensate for the losses). Subscribing to the theory that the value of a business is the discounted sum of its future cashflows helps with understanding this concept, but so does the simpler more colloquial theory "…you have to spend money to make money…". In the case of SaaS it appears that you are spending a lot of money to make money, but the key feature is the money that is made is recurring, into the future, for a very long time.

Scalability is such a key feature within the concept of the SaaS business model that when viewing an early stage SaaS business it should be expected that there are significant initial costs in product development and customer acquisition. Absence of these large near term costs can give an indication of the potential, or perhaps an underestimation by managers of these costs. To reiterate, making a loss is okay as long as the cause of this loss is creating stable future value; by having non-churning recurring revenues.

Funding the loss. SaaS companies can evolve out of an existing company responding to market forces, or more often from new business development. This new business development is often a big opportunity or a "good idea" that gets developed to a point where there is a proven market. At the early stage, this is usually funded by any means the founders can get their hands on, most likely their own time, supplemented with their own savings and perhaps funds from friends and family or government grants – the founders blood, sweat and tears stage. Whether at the end of this the company starts posting a profit, depends on the individual company and their internal business model, but if there is success in proving that there is a market for the developed product and a future in it, the next step is scalability and more funds are required. These are start-up growth companies and therefore there is an associated level of risk and any funds raised, generally private equity, are provided by people who understand the risk, but in return require a significant reward. Ultimately the company may remain privately held or list publicly, but the nature of SaaS companies is that in the near term they are growth companies and have an associated risk, but equally greater rewards than mature companies.

Finally, SaaS companies employ acronyms. Who doesn't? But if you are new to them they can be meaningless. So to save you from the embarrassment of asking, here are a few key ones that we have come across:

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SaaS – Software as a Service, is both a delivery method to the market and a product in itself.

ARPU – Average Revenue Per Unit, the key idea behind SaaS, this is the recurring amount received for each subscription to the software product, often a monthly amount (i.e. how much the company receives each month for each sale).

CMR – Committed Monthly Revenue, how much monthly revenue the company receives from the subscription to its software product. Very simply, it is the unit revenue (i.e. the ARPU) multiplied by the number of customers.

ACMR – Annualised Committed Monthly Revenue, simply put this is CMR multiplied by 12. This metric is often employed because in these high growth situations Year-to-Date (YTD) or Last-Twelve-Months (LTM) metrics miss the fact that the most recent month's revenues are the most representative of future revenues (assuming no further growth).

CAC – Cost to Acquire, this is generally presented as the cost to acquire a single customer and it encompasses all marketing and sales costs associated with acquiring the customer.

CTS – Cost to Serve, again presented as cost per single customer and encompasses the cost of storing (hosting) the customers data, operational support and customer service costs.

Churn – Strictly not an acronym, but is a common phrase in the SaaS world. Churn is customer turnover, often on a monthly basis presented as a percentage of total customers. Switching this concept on its head, the alternative is to think about how long a customer remains with the company. A key feature of the successful SaaS business model is low levels of churn.

LTV – Lifetime Value, this is the ARPU multiplied by how long the customer is expected to remain with the company (i.e. related to churn) and presents the value of the individual customer's recurring revenue. This metric is often presented alongside CAC where the story is that it costs x to acquire the customer which may seem a considerable amount, but over the course of the customer's time with the company, a total of y revenue will be received.

CAC Months of ARPU – Perhaps the Grandaddy metric for those in the SaaS world. Instead of presenting cost to acquire (CAC) in terms of dollars, it relates this cost in terms of the monthly revenue received from the customer (ARPU). So the metric is calculated as CAC divided by ARPU and if the ARPU is monthly then the result is the number of months of revenue required to repay the cost of acquiring the customer.

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- Assisting clients by completing analysis of issues.
- Assisting clients to complete commercial transactions.

Clare Capital provides advisory and transactional services across:

- **Mergers & Acquisitions (M&A)** – combining detailed financial analysis with extensive M&A experience to help our clients maximize outcomes.
- **Capital Management** – advising clients on their capital raising activities.
- **Corporate Finance** – combining fundamental corporate finance principles with real-world practical experience to provide clients with: valuations, capital structure advice, and option and incentive schemes.
- **Strategic Advice** – strategic and commercial advice to clients including: detailed strategic options analysis for clients facing key decisions and structuring and negotiating financial and commercial agreements.

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