Evaluating SaaS companies

A framework for evaluating SaaS businesses

Our framework answers five key questions

AlbionVC has been investing in software companies for almost 20 years, focusing on recurring revenue cloud businesses at the application layer. This primer sets out the basic framework we use to evaluate SaaS businesses.

In the Appendix on pages 14–15, we have also summarised our view of best practice approach to monitoring these metrics on an ongoing basis, together with an indication as to what ‘good’ metrics look like based on industry literature, surveys, public company information as well as analysis of our own portfolio companies.

- **We use this framework to help answer five key questions:**
- 1. Does the company provide a valuable service to its customers ?
- 2. Is the business model sustainable ?
- 3. Is there product/market fit in an attractive market ?
- 4. Can the company scale profitably ?
- 5. What is the company worth ?

1. Does the company provide a valuable service to its customers?

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1. Does the company provide a valuable service?

Renewals

At each renewal date, customers decide whether the value they get is worth the cost — factoring in competitive alternatives and switching costs.

Net churn

Shows ability to grow ASP over time and the annuity value of the customer base.

Churn

High churn signals problems: poor UX, product breadth, competitive dynamics, account management, or overselling. Each type tells a different story.

Logo churn

Customers lost as a % of total. Informs TAM and marketing/sales efficiency.

Gross churn

Shows whether the business retains its most valuable customers.

Non-financial

End-user usage statistics and NPS scores provide complementary insight.

1. Valuable service — useful metrics & analysis

Metric	What it measures	Formula / definition
Gross churn	Proportion of total revenue lost	*MRR lost in a given period/MRR at the beginning of a given period*
Net churn	Change in value across all existing customers (negative = growth from existing base)	*(MRR lost – MRR from upsells) in a given period MRR at the beginning of a given period*
Logo / Account churn	Ability to satisfy and retain customers	*Customers lost in a given period/Customers at the beginning of a given period*
Renewal rate	% of customers who renew at contract end	*Customers that renewed their contract at the end of a given period/Customers that could have renewed their contract at the end of a given period. Note: if you include customers that are bound by a contract, it will make it look like you are doing better than are*
NPS	Customer satisfaction — leading indicator of churn	*Index ranging from -100 to 100 that measures willingness of customers to recommend a company's products or services*
CX Index	How brand experience strengthens loyalty	*Index ranging from 0-100 that measures how effectively customers felt needs were met and the ease and enjoyably of their experience*
Cohort analysis	How churn and upsells trend over time	*Used to compare groups of customers by the month joined and follow how they behave over time*
Engagement	Cohort retention on metrics that matter	*DAU, MAU, photos shared, photos viewed etc.*
Usage	Specific to the company / application	*e.g. do 90% of users log in every day?*

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2. Is the business model sustainable?

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Traditional GAAP accounting is not as useful for SaaS businesses as for many other industries. In part this is because of the annuity nature of the revenues, where sales costs are expensed up front but revenues are recognised evenly over the lifetime of the customer. The effect is compounded further in high growth businesses

01 **Gross profit margin (%)**

Revenue / Gross profit — low % indicates heavy services layer

02 **EBITDA pre sales & marketing costs (EBITDASM)**

Underlying profitability: if you stopped investing in growth, is the business profitable?

03 **Rule of 40 (%)**

Growth rate + EBITDA margin > 40% — the healthy SaaS benchmark at scale

The Rule of 40

A high-level benchmark adding growth rate and EBITDA margin together.

Acceptable to be loss-making if growing fast; must be profitable as growth slows.

At scale: growth rate + EBITDA margin > 40%

However, in the end it all comes down to profitability and cash generation, and so we assess the long term viability of a business by reviewing the 'underlying profit' and unit economics.

2. Is the business model sustainable? (Metrics)

Useful metrics/analysis		
Metric / focus area	**What it measures**	**Formula / definition**
Gross Profit %	This is a traditional GAAP measure. Low GP % can indicate a heavy services layer, which will typically be less scalable	*Revenue/Gross profit*
EBITDASM (but incl. account management)	Measures underlying profitability i.e. if you stopped investing in growth, is the business profitable?	*Operating profit (including all R&D spend) with depreciation & amortisation and sales & marketing costs added back. But account management and customer success costs still included*
Rule of 40%	A rule of thumb measure for a 'healthy' SaaS company at scale	*Growth rate + EBITDA margin > 40%. Growth rate is defined as yoy growth rate of monthly MRR*

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3. Is there product/market fit in an attractive market?

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3. Product/market fit in an attractive market

Reviewing bookings, recurring revenue and ASP gives insight into growth potential and the TAM.

Growth

— Product market fit is nebulous — a company not growing fast hasn't demonstrated it

— We review:

- Bookings growth,
- MRR/ARR growth,
- New logos

Trends in ASP over time

— ASP informs Go To Market strategy

— Low ASP won't support long, expensive field sales cycles

— High ASP may require more than inbound marketing alone

Market sizing

— What defines an attractive market is complex

— The Total Addressable Market must be large

— TAM / SAM / SOM give different lenses on opportunity

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3. Product/market fit — useful metrics & analysis

Metric	What it measures	Formula / definition
Bookings growth	Leading indicator of growth rate (especially early stage)	*Monthly or quarterly ACV*
MRR growth	How quickly recurring revenue is growing	
Increasing ASP / deal size	Acquiring higher-value customers; enables high-touch sales	
New MRR v Expansion MRR	Whether growth comes from new or existing customers	
Quick ratio	Growing at healthy rate with low enough churn	*(New MRR + Expansion MRR) / (Churned MRR + Contraction MRR)*
TAM	Total addressable market size	*Everyone worldwide who could buy your product*
SAM	Serviceable addressable market	*Market you can acquire with current product (geography, vertical)*
SOM	Serviceable obtainable market	*Portion of market reachable now (e.g. SME vs Enterprise)*

4. Can the company scale profitably?

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4. Can the company scale?

Understanding the business model

- Sales efficiency metrics, together with gross margin analysis and deployment model understanding, give insight into scalability, viability and efficiency.

Go To Market strategy

- Every great business needs an effective GTM strategy. For SaaS the impact is pronounced given the simplicity and profitability of delivering a standardised service over the web.

Key metric: cost vs value

- SaaS companies review sales and marketing costs to acquire a new customer against the lifetime value of that customer once won.

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4. Scaling — useful metrics & analysis

Metric	What it measures	Formula / definition
Blended CAC	How much to spend on sales & marketing to acquire one customer	*S&M costs / # new customers (factor in sales cycle length)*
Paid CAC	Spend on paid campaigns to acquire one customer	*Paid S&M costs / # new customers*
Customer lifetime	Customer lifetime in months or years	*1 / churn rate % (e.g. 3% monthly churn = 33 months)*
LTV	How much each customer contributes to revenue and for how long	*ARPA × gross margin × customer lifetime*
CAC payback	How long before a new customer pays back acquisition costs	*CAC / (ARPA × gross margin)*
LTV:CAC ratio	Cost to sign vs. value of that customer to the business	*LTV / CAC*
Magic number	For every £1 in S&M, how many £ of ARR created — profitability of the model	*(Δ subscription revenue Q-on-Q × 4) / S&M spend in prior quarter*

4. Scaling — additional metrics

Metric	What it measures	Formula / definition
S&M costs as % revenue	Rate of investment in growth	*S&M costs / total revenue*
Professional services %	Recurring nature of revenue and total cost of service	*PS revenue / total revenue*
Attachment rate	PS revenue as % of first-year ACV — role of PS in deployment and GTM	*PS revenue / ACV in year 1*
Gross capital consumption	How much capital has been consumed to grow ARR	*Gross cumulative capital consumed / ARR achieved*

5. What is the company worth?

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5. What is the company worth?

The $$$ question.

To the extent we are using science rather than art, we typically focus on the metrics in the table opposite.

The last point (cash generation) is important – a fast growing company whose customers pay annually up front is going to be significantly cheaper to finance than one paid monthly in arrears, and so less capital will be required to build the same value.

ARR	Revenue retention / net churn
ARR growth rate	ASP growth
GP %	TAM
EBITDASM	CAC payback & LTV ratio
Gross churn	Cash generation

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What should SaaS businesses measure?

A. Detailed Analysis: The Customer Lifecycle as a Dashboard

Process designed by Keith Wallington

Discover

Leads

Evaluate

Demo views
Content downloads
Live chat users

Buy

new customers
New MRR / MRR or
CMRR* / APRA
CAC /CAC Ratio

Renew

LTV
LTC: CAC ratio
Churn

Buy more

Upsells
New upsell MRR
ARPA by cohort

Get support

KB Traffic
Support
Customer Satisfaction (Cxi)
# of support cases

- Promotes a customer centric approach
- Aligns with customer development and lean methods
- Keeps the team aligned (use to set lead & lag goals and OKR's)
- Effective way to understand your business and explain how it works
- Look for insights not just in each stage but across the lifecycle
- Identifies and promotes focus on the bottle necks that need addressing now
- Keeps you connected to your customers
- Drives scale!

Every business is unique and the mix of metrics should be adjusted accordingly. The philosophy of thinking about your business in this holistic way is what is important.

*CMRR = MRR + committed signed contracts = churn (including predicted churn)

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The top metrics to track

B. High-level Analysis: The Top Metrics to Track

01 ARR

Annual recurring revenue — the north star metric

02 Net churn

Direction of travel for existing customer value

03 ACV

Annual contract value — deal quality signal

04 # of customers

Total logo count and growth rate

05 CAC payback

Efficiency of customer acquisition

06 Gross margin

Foundation of scalability

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Glossary

Key terms and definitions

ACV	Annual contract value	**KB**	Knowledge base
APRA	Average revenue per account (MRR divided by no. of active accounts)	**LTV**	Lifetime value
ARR	Annual recurring revenue	**MAU**	Monthly active users
ASP	Average selling price	**MRR**	Monthly recurring revenue
CAC	Customer acquisition cost	**NPS**	Net promoter score
C2S	Click to scan	**OKR**	Objectives and key results
CMRR	Committed monthly recurring revenue (existing MRR plus new bookings less downgrades & churn)	**PS**	Professional services
CXi	Customer experience index	**S&M**	Sales and marketing
DAU	Daily active users	**TAM**	Total addressable market
GTM	Go To Market		

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LTV	https://labs.openviewpartners.com/what-are-key-performance-indicators-6-saas-metrics-that-really-matter/#.Wd0F7WhSyUI
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S&M costs as a % of total revenue	https://labs.openviewpartners.com/saas-sales-budget/#.Wd0LHmhSyUk
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Thank you.

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