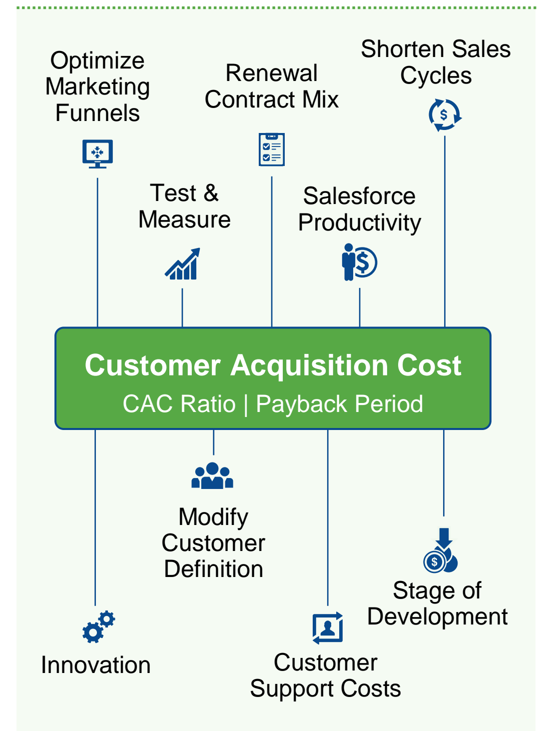
SaaS Metrics that Drive Valuation

Acquiring Customers at the Right Price

By Jeff Houston, CFA

The costs associated with acquiring customers, also known as CAC, is one of the most important SaaS metrics because it demonstrates how much a company spends on sales and marketing (S&M) to add new customers. CAC includes everything it takes to land customers, such as advertising, marketing, sales, trial support, and on-boarding as well as the costs associated with prospects that did not become customers. Because companies are tempted to pursue customers regardless of cost, time, and relative/absolute results, CAC also serves as a sanity check for customer lifetime value (CLTV). For a detailed discussion of CLTV, please view the "Top CLTV Pitfalls" note previously published in our SaaS Metrics that Drive Valuation series.

Navidar helps our clients understand and holistically optimize CAC while incorporating CLTV and other critical SaaS metrics to maximize exit valuation. We have been the trusted advisor for many SaaS companies that call the middle-corridor of the U.S. home. Collectively, our team has completed more than 300 transactions, representing $70 billion in M&A, capital raises, and public offerings. In this article, we identify our favorite CAC metrics as well as multiple points to consider while striving for excellence.



CAC Definition. The most common CAC formula is S&M expenses divided by gross customer additions. We generally use a full year of S&M and customer adds in our CAC analysis. However, for companies with very short or long sales cycles it can make sense to use adjusted periods for one or both of these metrics.

CAC ratio is CLTV divided by CAC. Companies generally seek to minimize CAC while maximizing CLTV to optimally develop and enhance profitable, long-term customer relationships. The CAC ratio, in our opinion, should be greater than 2.5x for consumer-focused and ecommerce companies and greater than 6.0x for best in class SaaS companies, indicating that 17% or less of CLTV is spent on CAC. If this ratio is less than these benchmarks and does not improve over time, then the company may have difficulty in achieving and sustaining appropriate levels of cash flow generation. Still, there are numerous reasons for a CAC ratio to temporarily dip below these watermarks, such as an early-stage of corporate development, a new/young sales team, or upon entering new markets.

Payback period is typically defined as the latest quarter's S&M expense divided by (new recurring revenue times gross margin). This metric demonstrates the number of months it takes to pay back S&M expenses when acquiring a new customer. For SMB focused SaaS companies, payback can be as low as three to five months and for those focused on enterprises, it can be up to three years. While the lower the CAC payback period, the better in general, a low payback can also indicate opportunities to increase S&M spend.

Factors to Consider When Optimizing Customer Acquisition Cost

Optimize marketing funnels. By breaking out CAC information based on geography, vertical, size, buyer persona, renewal client, new client, and marketing channel, companies can quantify and optimize marketing funnels. As a result, they can meaningfully improve S&M effectiveness, which reduces CAC.

Test & Measure. While constant testing and measurement of new sales and marketing channels, strategies, and tactics increases S&M expenses, failing to do so can result in missing customer additions and future revenue.

Renewal contract mix. As a company's mix of existing/renewing customers, which carry higher profit margins, begins to outweigh new customers, which carry lower margins, overall company profitability typically follows suit. This beautiful aspect of the SaaS business model occurs because after CAC is covered, customers are quite profitable.

Salesforce ramp time and productivity. It is important to understand and communicate the time it takes for new sales people to reach full productivity (typically three to 18 months). Because when salesforce attrition temporarily ticks up or a meaningful number of salespeople are added, it can make sense to adjust CAC accordingly. In addition to salesforce ramp time, we have also helped our clients embark on initiatives that lower CAC by improving salesforce productivity, such as adjusting incentive compensation and implementing sales enablement technology.

Shorten sales cycle. Reducing the sales cycle places downward pressure on CAC. Navidar encourages our clients to identify and remove friction in the sales process by adopting industry best practices and implement vigorous A/B testing on critical elements such as pricing, packaging, website layout, user experience, and sales processes.

Innovation. Product innovation leads to more solutions for sales teams to sell. Building and growing solution suites generally translates into higher sales productivity and improving CAC.

Modify customer definition. Customer churn rates for best in class SaaS companies is 5-15% annually, but higher (20-30%) for SMB-focused companies and even higher (up to 70%) for those focused on consumers or ecommerce. In these situations, it can make sense to add parameters to the definition of a customer, such as identifying and excluding "trial" customers. Doing so can create a more accurate view of CAC.

Customer support costs. In striving for accurate CAC, when a high percentage (30-50%) of new business is driven by customer referrals (also known as word-of-mouth marketing), we recommend including up to 15% of customer support costs in the CAC formula.

Stage of corporate development. For companies in early stages of corporate development, we may adjust CAC lower when S&M salaries are unduly burden for hiring personnel who can scale with growth.

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