INSIGHTSQUARED

Board Meeting Essentials

SaaS Finance KPIs

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Introduction

It's time for another Board Meeting, and your Board members are clamoring for up-to-date information about your company's financial situation. Do you know what they're looking for? Do you know which KPIs tell the most accurate story about where your company has been and where it's going?

If you don't, you're not alone. Board meetings can be daunting, and many executives struggle to create the best presentation. This is especially true in terms of financial metrics for SaaS companies. The SaaS world is always changing, and every quarter brings new thoughts about the best practices for evaluating a company's financial standing.

Caught in this predicament, SaaS executives struggle to use their Board meetings effectively. Half the time they omit important metrics, which leaves Board members scratching their heads and wondering why such obvious information is absent.

The rest of the time, executives include too much information – throwing dozens of metrics against the wall to see what sticks. The result? A collection of Board members overwhelmed by data, hungry for a coherent story about how the company is faring.

Don't be one of these executives. In this eBook, we analyze the **5 essential finance metrics** that all SaaS companies should include in their Board meetings:

1. Revenue Growth
2. Cash Flow
3. Profit Margins
4. Churn
5. Bookings

Important Note: Unit economics have become increasingly important for SaaS companies. We cover some of the most fundamental unit economic metrics in this eBook – such as Lifetime Value (LTV), payback period, and Gross Margin – but for a more thorough analysis, please look for our upcoming eBook on SaaS metrics.

Revenue Growth

For early-stage SaaS companies, revenue growth is the most important financial KPI. Future profitability typically trumps present profits, and as long as there is an investor who sees real potential in your business (and is willing to put up the cash), a young SaaS company can live in the red for quite some time. Therefore, instead of net profit, Boards tend to view revenue growth as the best metric for judging a growing SaaS company's upside.

For SaaS companies in high-growth phases, it's not uncommon to see year-over-year growth in excess of 100%. The Board will want to know if revenues are trending consistently upward or staying flat. Furthermore, many companies split revenue growth into two categories -- subscription and professional services revenue -- to give them a clearer picture of where their revenue growth is coming from. A general rule of thumb is that if more than 20% of a company's revenue is coming from professional services, you have a problem. If it's significantly less, you probably have an opportunity to expand your revenue base.

It's really that simple. Your company's value to an investor hinges on its revenue potential, so you should lead off your Board presentation by showing revenue growth over time.

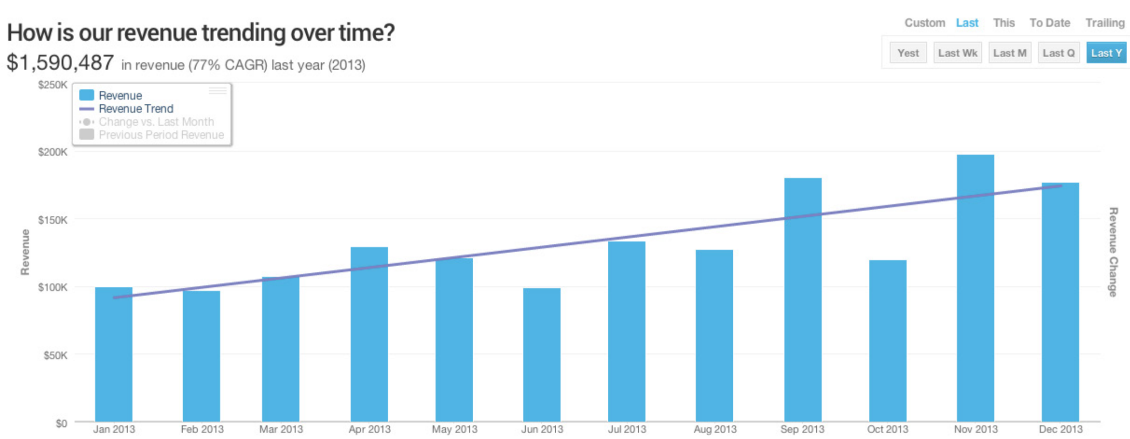

Figure 1: The chart above shows revenue by month as well as the growth trend over time.

Cash Flow

SaaS companies, particularly young ones, have complicated cash needs. They typically require a steady stream of resources to support their operations and bankroll their growth – even before they see a single cent of profit. These resources don't always come cheap, and they're are often quite limited. If you run through your cash reserve too quickly, the Board may infer that you don't have control over your cost structure.

The way Boards typically evaluate a company's ability to manage this reserve is by monitoring its cash flow. It's common for a young SaaS company to have negative cash flow. The process of establishing your company's infrastructure, hiring the right people, and funding everyday operations requires a lot of cash. However, it is important for growing SaaS companies to keep careful track of their cash position, which means knowing, on a regular basis, how much cash came in, how much went out, how much is left, and why. The Board will want to know this too, so every growing SaaS company should have this information readily accessible and clearly presented.

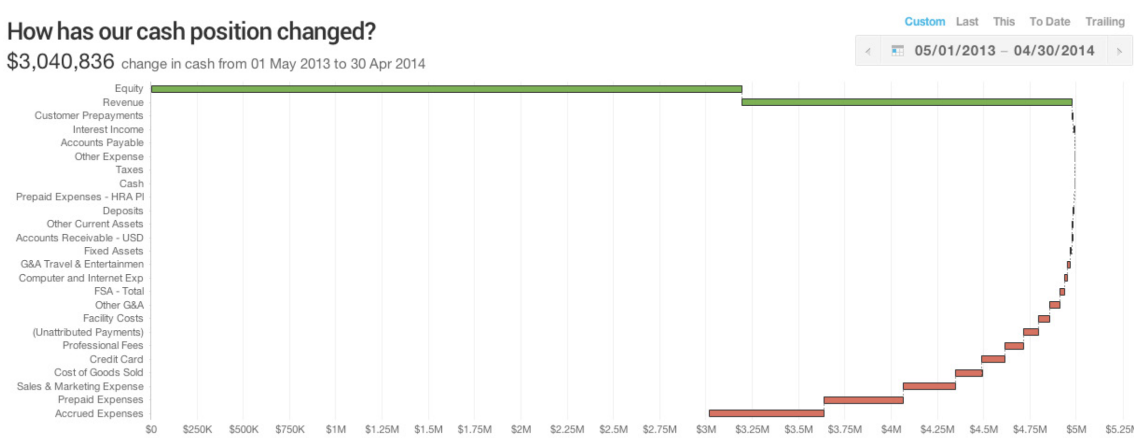

Figure 2: The chart above shows how cash flow changed during a given time period -- where cash came from, where it went and, what the current cash position is.

Profit Margins

Although, as we've already discussed, profits aren't as essential for young SaaS companies as they are to most businesses, margin analysis is still a KPI that most Boards care about. Margin analysis can give deep insight into how different segments of your business are helping or hurting your bottom line. When looking at margins, it's easy to fixate on net profit margin, but you should also pay attention to gross profit margin, operating profit margin, and even contribution margin.

Each of these metrics gives you insight into how different cost categories affect your net profit. Gross margin takes into account only costs that are directly related to creating a product. If your product costs are high, then you might need to take action to rein them in or find ways to keep operating costs down.

Operating margin takes into account product costs as well as selling, general, and administrative costs to give the percentage of revenue remaining before deducting financing costs. This is where most companies get buried, especially young SaaS companies, who often invest heavily in salaries, which push operating margin down.

To get a slightly different perspective on your bottom line, you can conduct a cost-volume-profit analysis to calculate contribution margin and infer your firm's degree of operating leverage. In this regard, leverage doesn't necessarily refer to debt, but instead to how much of a company's cost mix is fixed. Companies with high fixed costs are susceptible to large swings in net income caused by relatively small changes to sales revenue. The contribution method can show you, very simply, if you have an effective operational model. Cost categories are ignored and total variable costs are subtracted from sales revenues to compute contribution margin.

You can then subtract total fixed costs to get a figure for operating profit, and ultimately net profit. The profit figures will be the same as those reflected in a generally accepted accounting principles (GAAP)-friendly income statement, but the contribution method will simply give you a different perspective.

New thinking says that GAAP metrics are not as useful for evaluating the financial health of SaaS companies, and that more SaaS-specific metrics like LTV : CAC and "Magic Number" metrics are increasingly useful. However, many Boards still value profit margin, so you should be prepared to show them yours at your next Board meeting.

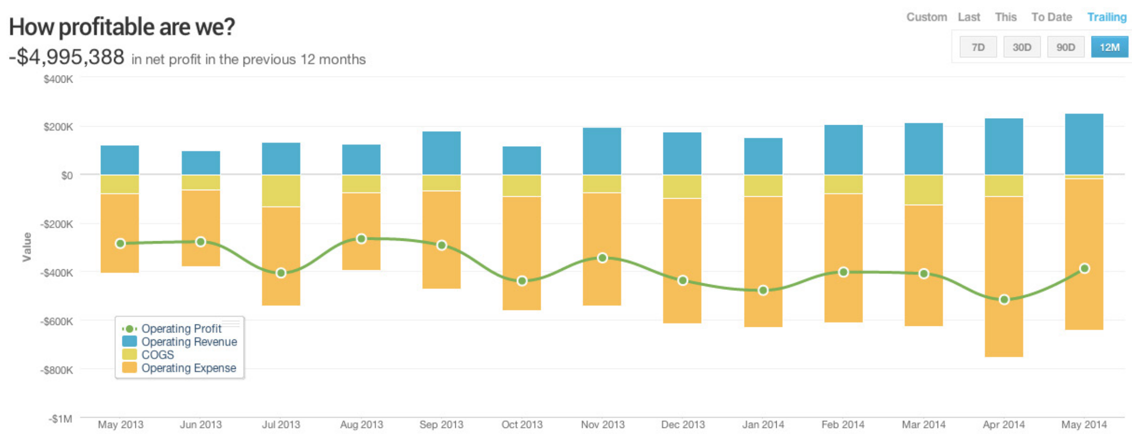

Figure 3: The chart shown above shows net profit over time, broken down by revenue and expenses.

Churn

When the Board sits down to assess your company's risks, they typically divide them into two main buckets: business risks and financial risks. Business risks reflect variability in the everyday operations of the company -- fluctuations in sales revenues and input costs, for example. Financial risks pertain to how a business is leveraged and the costs associated with funding source(s) -- interest payments on long-term deals, for example.

For SaaS companies, the most important business risk is churn rate. And even though churn rate is a business risk and not a financial risk, it is still critical to financial success, so many SaaS companies rightfully decide to present it to the Board as a financial KPI. And all finance professionals should make sure they have clear visibility into their company's churn rate.

Accurately assessing (or even defining) churn rate is complicated and much-debated. There are 3 principal ways of measuring churn rate: account churn, revenue churn and revenue churn excluding upsells. Revenue churn is the most common and, therefore, the KPI most Boards are likely to ask about.

Revenue churn (also known as "logo churn") refers to the number of customers who discontinue their subscription in a given time period. The advantage of using revenue churn is that it offers a relatively simple way of understanding the share of customers you are losing during a given time period. The disadvantage is that it doesn't consider the size of the customers you're losing. (Whether or not the Board asks about them, you should be looking at the other two churn metrics for a more complete picture of how churn is affecting your business.)

It goes without saying that in order to grow you need to be adding more revenue than you're losing. But for a SaaS business to have any chance of long-term survival (and to satisfy Board expectations), you need acquisition to significantly outpace churn. Acquiring new customers has significant costs, but earning more revenue from existing customers is much less expensive.

Churn rate is also important to your Board because it gives them a line of sight into your unit economics. A high churn rate jeopardizes the lifetime value (LTV), which can raise a red flag to your Board. At this point during your presentation, you might also want to discuss your payback period, which is your customer acquisition cost divided by your Gross Margin. Boards of SaaS companies are increasingly concerned with unit economics, and this is a good place to discuss how your churn rate factors into your profitability on a per-unit basis. (If you're still curious about unit economics and other cutting-edge SaaS KPIs, stay tuned for our upcoming SaaS metrics eBook.)

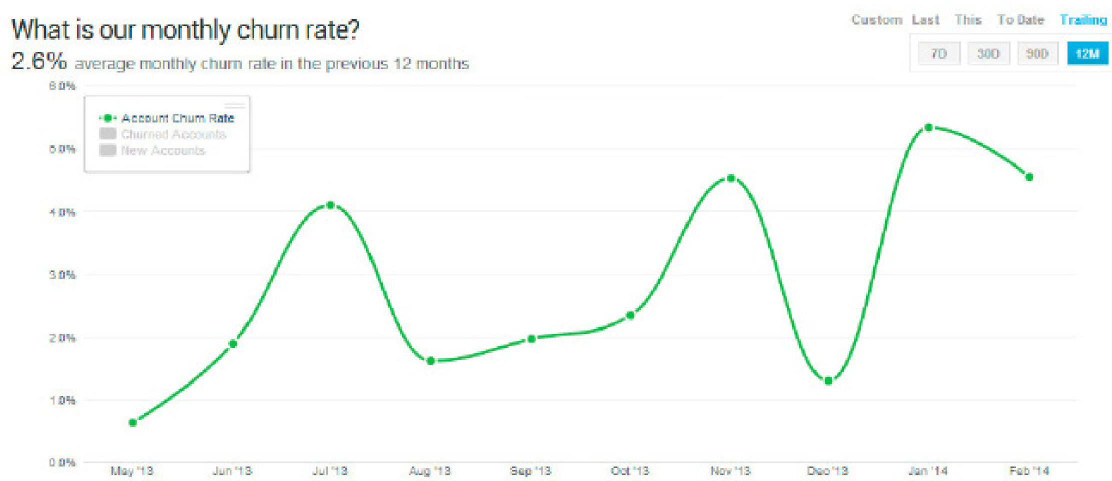

Figure 4: The chart above shows the percentage of accounts that churn on a monthly basis over time.

Bookings

Even in SaaS companies, new bookings are an essential KPI for evaluating financial health. New bookings demonstrate growth potential, strong product-market fit, and stability -- so Boards are anxious to see SaaS companies with steadily rising bookings.
In the non-subscription business world, Board typically look just at revenue and are able to get a clear understanding of the trajectory of the business. In the SaaS world, this is not really the case because revenue is such a lagging indicator. Instead, SaaS companies usually look to bookings for a more accurate picture of growth.

However, there is a problem: Bookings are not held in the highest esteem in GAAP circles. Consequently, there's no standardization about what companies include (and Boards expect) in their bookings reporting. That means there's a lot of room for miscommunication (or, even worse, intentional misleading) when it comes time to report bookings figures.

Because of this, it is incredibly important for SaaS companies to be extremely clear about how they are measuring and reporting bookings. Are you including renewal contracts? How do you account for multi-year contracts? Most of these choices are fine as long as they are explained openly and unambiguously.

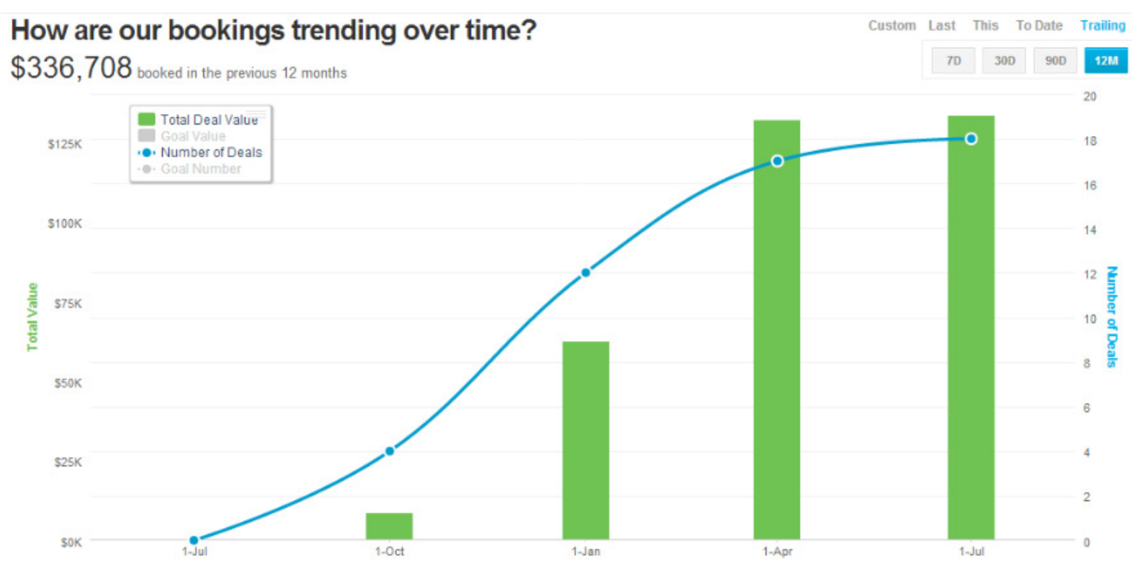

Figure 5: The chart above shows bookings growth over time as measure in Annual Contract Value.

Conclusion

Understanding these 5 SaaS financial metrics should leave you in a better position to prepare for your Board meetings and help you establish a better system for measuring and managing your own finances. In a Board Meeting, or any meeting with a third-party investor, your business will be judged on its financial fundamentals. Are you in a viable market? Do you have an effective operational model? Do you have the discipline to keep costs under control?

These metrics serve as a jumping-off point for thinking critically about your business' financial performance. Not only will you have the basic metrics you need to assess your company, but you will be challenged to think even deeper.

The five metrics are as follows:

1. Revenue Growth
2. Cash Flow
3. Profit Margins
4. Churn
5. Bookings

With these metrics, you'll be able to answer the above questions, and many more.

Powerful QuickBooks Analytics

About InsightSquared

InsightSquared offers best-in-class finance, sales and marketing analytics for small and midsize businesses (SMB). Unlike legacy business intelligence platforms, InsightSquared can be deployed in less than a day without integration costs and comes preloaded with reports that real business people can use. Hundreds of companies and thousands of users around the world use InsightSquared's award-winning analytics to maximize performance, increase productivity and grow revenue. Based in Cambridge, Mass., InsightSquared was recently named one of the "Best Places to Work in Massachusetts" by the Boston Business Journal.
For more information, visit www.insightsquared.com.

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