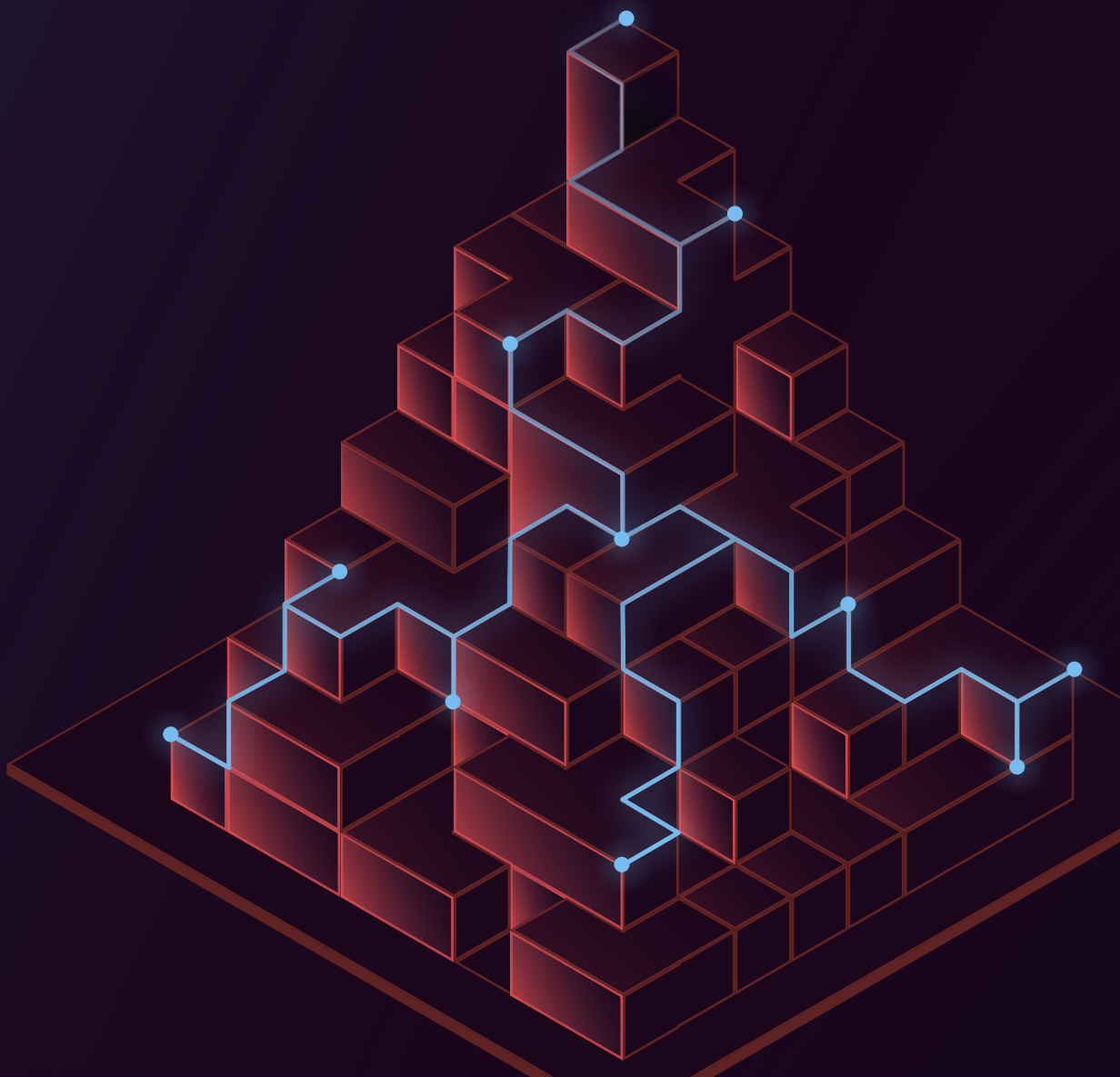
Drivetrain

EBOOK

SaaS Metrics Based Planning

A proven top-down approach to SaaS financial modeling



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Introduction

> By failing to prepare, you are preparing to fail.
>
> **Benjamin Franklin**

Planning is the first step towards achieving your company's goals.

But where does one start?

For B2B subscription-based businesses, this comes down to a few SaaS metrics that play a crucial role in evaluating business health.

Your existing investors keep a close watch on them, and prospective investors evaluate the strength of your business on those metrics. Not to mention they also act as primary inputs for determining your company’s valuation.

But are you designing your plans around these SaaS metrics? Are these metrics getting the attention they deserve in your planning process? Is your business plan crafted to help you achieve these metrics at a healthy level so that your valuation is optimized?

If your answer is no, it is worth stepping back and rethinking your planning process.

Planning for success

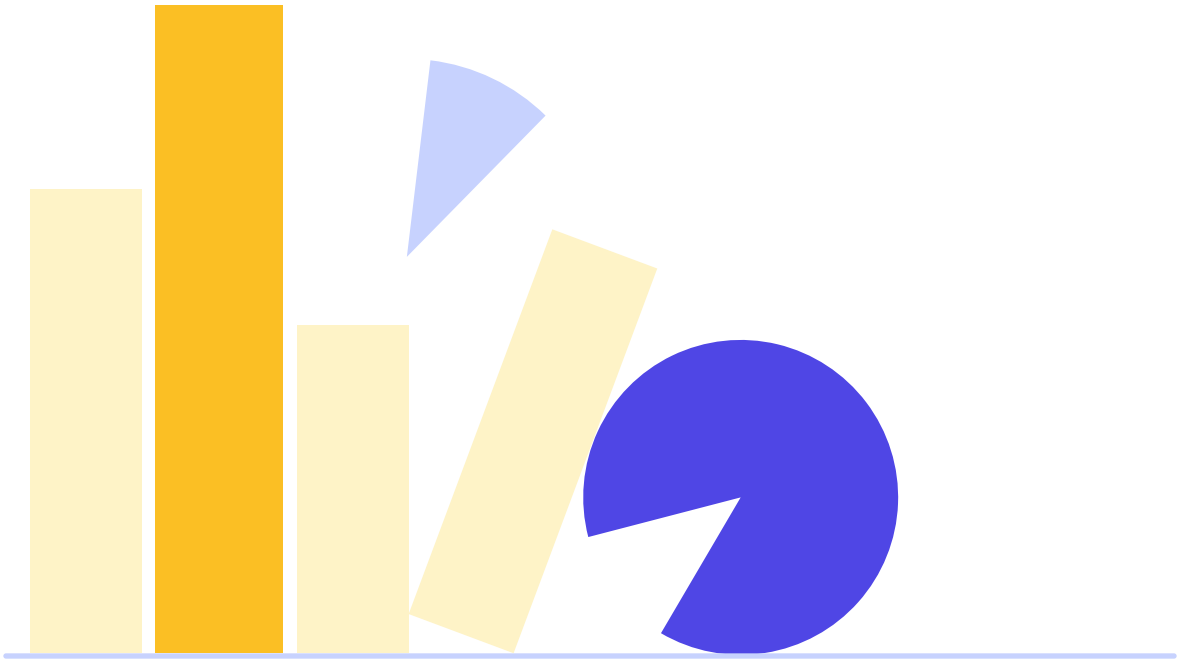
While there are several frameworks to plan and model top-line revenue, most fast-growth SaaS companies begin with a top-down approach.

This is logical since the CEO and the board set the objectives (goals and targets) for the fiscal year ahead. A top-down approach makes it easier to translate these objectives into functional targets. The executive leadership and senior management set high-level budgets based on these objectives which serve as constraints for building departmental bottom-up plans.

But, this is also the most complex part of the planning process. Since these metrics impact each other, tradeoffs become inevitable. The targets set at the beginning of the top-down exercise might end up not being too aspirational and require several revisions. Consider the following scenarios:

- Increasing the customer success headcount might reduce churn but will impact your Cost of Goods Sold (COGS) and consequently Gross Margin and Operating Expenses.
- Bringing in more experienced sales personnel might increase both deal closures and pipeline velocity, but it affects the customer acquisition cost (CAC) and payback period.

Thus, striking the right balance between multiple metrics is central to creating feasible top-down plans. Getting there quickly helps save significant time and effort throughout the planning process, creating more efficiency.



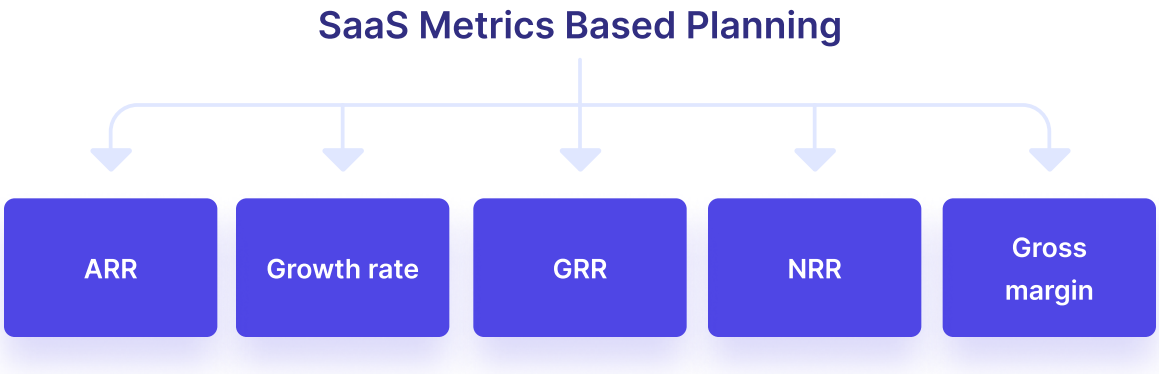
Which SaaS metrics are vital for planning success?

It's clear that tracking SaaS metrics accurately is crucial since misinterpreting or measuring them incorrectly could adversely affect your ability to grow.

There are dozens of SaaS metrics to track. Focusing on the wrong ones would take you further away from achieving your goals. And monitoring too many metrics means finding the right balance and managing those tradeoffs between them becomes an impossible task.

As it turns out, you only need to focus on five metrics alongside the 'Rule of 40'. They are:

- Annual recurring revenue (ARR)
- Growth rate
- Gross revenue retention (GRR) rate
- Net revenue retention (NRR) rate
- Gross margin



From here, the plan is gradually developed down through your organization's hierarchy with slightly more aggressive internal targets.

Before we show how this is done with an example, let's explore the role of these five metrics that form the basis for SaaS Metrics Based Planning particularly on your company's valuation and health.

Annual recurring revenue (ARR)

ARR is arguably the most important metric in determining your company's valuation. It indicates the health of a subscription business as it shows where revenue is growing or being lost.

Note: If your pricing strategy is based on monthly recurring revenue (MRR), one way to calculate ARR is to summarize all the revenue received from paying customers per month and multiply it by 12. This is also termed as 'Annualized Run Rate'.

Growth rate

The revenue growth rate is a useful metric in predicting the future performance of your company. It is a powerful indicator of your company's momentum.

Thus, the higher the growth rate, the higher the valuation.

Gross revenue retention (GRR) rate

GRR shows how successful a company is in retaining its existing customers. For example, if you start the year at $10 million ARR, at a GRR of 70%, you will end the year at $7 million ARR from that group of customers.

GRR points to the long-term health of the business. Since you cannot upsell or cross-sell to customers who have churned, it indicates the percentage of expansion opportunities you have over time.

Note: GRR excludes any price increases in its calculation.

Net revenue retention (NRR) rate

NRR is the recurring revenue retained from your existing customers in a calendar year.

It is an indicator of your company’s ability to retain and expand contracts. Thus, a higher NRR rate is more attractive to investors in the near-term especially if you are growing fast and valued on growth.

Gross margin

Gross margin (%) tells us what percentage of each dollar of revenue your company retains. If your company's gross (profit) margin is 75%, it means you retained $0.75 from each dollar of revenue you generated.

Thus, higher gross margins are preferred for higher valuations.

SaaS Metrics Based Planning methodology explained

Let’s take an example to illustrate how to apply the SaaS Metrics Based Planning approach.

Acme is a fast-growth SaaS company with an annualized run rate (ARR) of **$30 million**, operating in US and EU markets and catering to two market segments.

Targets set by the board are as follows:

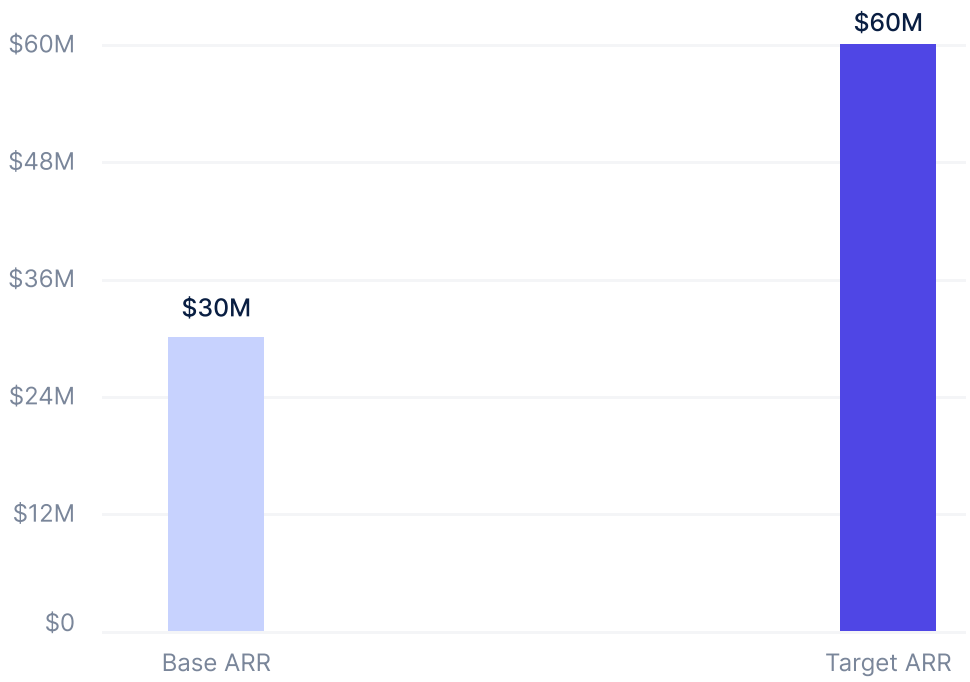
- Growth rate: **100%**
- GRR: **80%**
- NRR: **130%**
- Gross margin: **80%**
- **Rule of 40**

Let's start with the first two metrics - ARR and Growth Rate %.

At a growth rate of 100%, the ARR target for the next fiscal year is given by:

`Target ARR` = `Current ARR` x (1 + `Growth Rate %`)

This works out to be **$60 million.**



Next, let's take the GRR metric from which we can compute the upper bound for Churn ARR given by:

`Annual Churn Rate %` (upper bound) = 1- `GRR Rate %`

Thus, an 80% GRR translates to an annual churn rate of 20% that includes downgrades, cancelations and expirations. From this, we can compute the upper bound for the Churn ARR as follows.

`Churn ARR` = `20% of $30 million` = `$6 millon`

Note

The upper bound for the Churn ARR dictates the maximum **Monthly Churn Rate (1.84%)** that Acme can tolerate without underperforming on the GRR metric.

The formula used to compute the monthly churn rate is given below.

```
Monthly Churn Rate % = 1 - (( 1 - Annual Churn Rate % ) ^ (1/12))
```

Moving onto the NRR KPI.

A 130% NRR requires Acme to expect its current ARR to grow from $30 million to $39 million from its existing customer base. This is computed using,

```
Current ARR x NRR %
```

Thus, they will need to add **$15 million** ($39 million - $24 million) in expansion revenue from the same cohort accounting for the $6 million in churn.

From the GRR and NRR targets, we have determined the bounds for both Churn ARR and Expansion ARR. These numbers will serve as targets for the Customer Success and the Farming teams to build their plans.

From the chart below, Acme needs to bring in **$21 million** in New ARR in the next fiscal year to achieve its $60 million target.

`New ARR` = `Target ARR` - (`Current ARR` x `NRR %`)

This would serve as the target for the Hunting teams across sales and marketing.

The remaining KPI, Gross Margin, along with the Rule of 40, sets the constraints on Cost of Goods Sold (COGS) and EBITDA, respectively.

For example, from Gross Margin, we can compute the upper limit for COGS using,

> `COGS` = `Revenue` `( 1 -` `Gross Margin %` `)`
>
> This works out to be **$12 million.**

The line items (cost centers) that go into calculating COGS are,

- Customer success and support
- Server infrastructure costs - usually taken as a percentage of MRR, and
- Payment processing charges

Note

Some SaaS companies prefer to keep the customer success (CS) cost center under sales and marketing (S&M) in operating expense (OpEx) instead of COGS.

There's no definitive answer here. A simple rule of thumb is if your CSM team holds a quota for expansion (plan or seat upgrades, selling add-ons and cross-sells), where either there's an overlap with the account management function or they take on a part of it, then it makes sense to keep it under S&M. If they don't hold a quota, then it's recommended to keep this line item under COGS.

Similarly, EBITDA can be computed using,

```
EBITDA margin % = Rule of 40 - ARR Growth Rate %
```

This gives us the upper bound for the EBITDA margin of **-60%** and an EBITDA of **-$36 million**

From both these metrics, we can compute the upper limit for operating expenses given by,

`Operating expenses` = `Gross Margin` - `EBITDA`

This comes to **$84 million.**

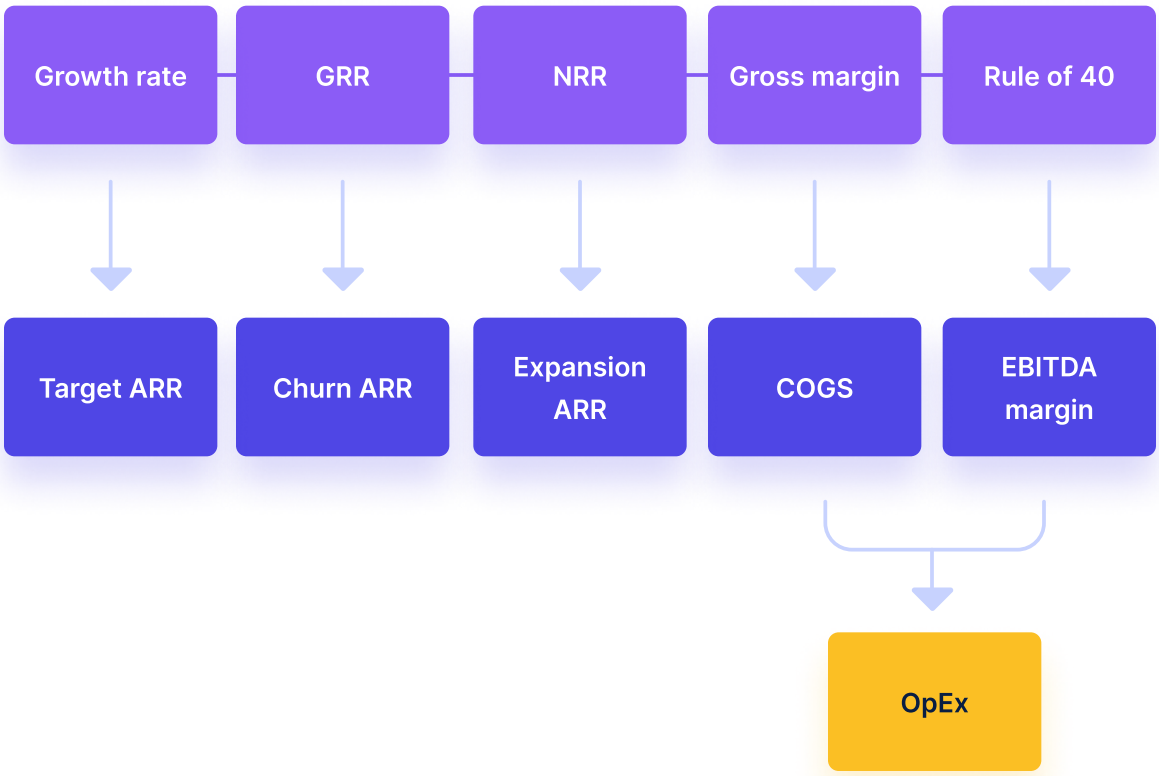
Operating expenses can further be split into

- General and Administrative (G&A) expenses
- Sales and Marketing (S&M) expenses, and
- Research and Development (R&D) expenses

Summary of metrics computed thus far

Metric name	Value (upper bound)
Target ARR	$60 million
Monthly churn rate % (upper limit)	1.84%
Churn ARR (upper limit)	$6 million
Expansion ARR	$15 million
New ARR	$21 million
COGS	$12 million
EBITDA margin %	-60%
EBITDA	-$36 million
Operating expenses	$84 million

The numbers computed thus far serve as inputs across customer-facing functions. From marketing to sales quota and capacity planning to customer success planning, the respective teams can either develop bottoms-up plans with these targets set as constraints or continue with top-down plans to meet these targets.



Note

It's important to identify the downstream metrics that support the metrics just computed. This would help make the plan more flexible in responding to market changes and get you closer to predictably achieving your targets. All of this requires having the right systems in place.

If you are managing these KPIs and metrics on Excel, then it would be time-consuming and cumbersome. The management is better off using their time and expertise to help inform strategic decisions. What is needed here is an automated way to get this critical information to guide your strategy.

Summary

A top-down plan is a great place to start.

By not focusing on all of the metrics that influence revenue and starting with just a handful of SaaS metrics set at the board level, the task becomes easier.

While the planning exercise is often referred to as an art, it can be broken down to a hard science as illustrated in the SaaS metrics based top-down financial planning approach.

The increasing popularity of SaaS metrics based planning approach lies in its simplicity. It makes it more actionable and helps you quickly gauge whether the KPI goals are feasible or too ambitious. It also sets the constraints (upper bounds) for several downstream metrics right at the beginning before your tactical plans are built. By knowing these constraints early on, it helps you avoid over-budgeting, overstaffing, and other planning errors.

> SaaS Metrics Based Planning helps SaaS leaders be the architect of their business. It helps you create more accurate and feasible plans while significantly reducing planning cycles.
>
> But more importantly, it gives you the confidence to achieve the outcomes set at the board-level. We have observed firsthand how SaaS companies who have adopted this approach are more predictable and thus attract much higher valuations.

Alok Goel
CEO and Co-founder, Drivetrain

When combined with Drivetrain software, it can help you manage and scale the business strategically while driving alignment and visibility across the organization.

We hope you found this eBook helpful and practical enough to be put into action.

If you would like assistance in deploying the methodology shared here, reach us at **learn@drivetrain.ai**.

About Drivetrain

Drivetrain helps SaaS companies plan, manage and scale their businesses predictably with greater visibility and control.

Drivetrain helps teams with the information they need to work together to create and align on a single plan for their business. It provides executives the big picture perspective on where precisely their plans and efforts are having the most impact. Thus enabling them to optimize their plans and make decisions with informed confidence at the right time.

Drivetrain

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