8020 CONSULTING

Best Practices for

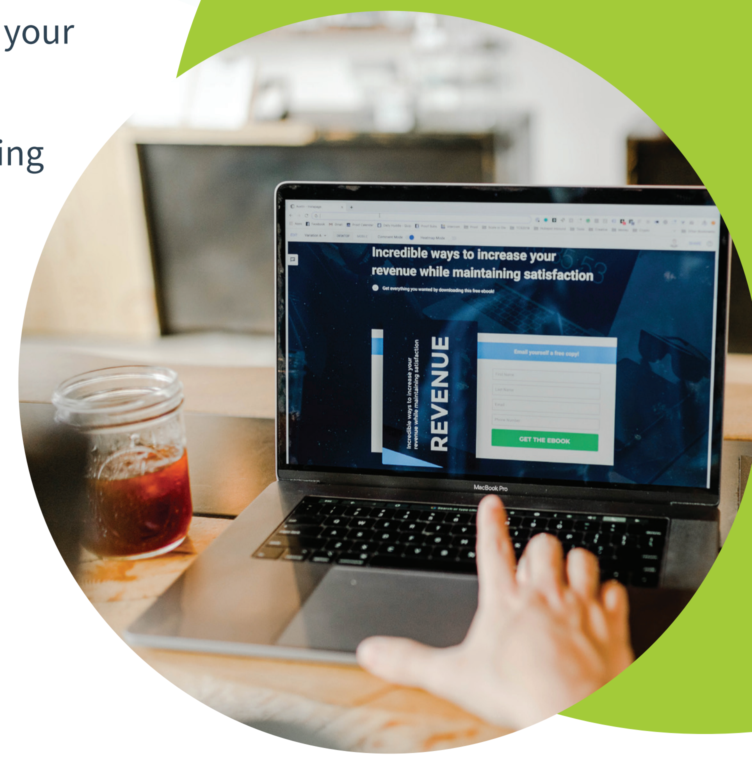
SUBSCRIPTION-BASED FINANCIAL MODELING

Building a Subscription-Based Forecast Model

Subscription-based businesses are rapidly replacing traditional product sales models. Whether you're a new subscription business or an existing business pivoting to a subscription model, you need a corporate financial model that captures all the intricacies associated with subscriptions. If you're operating using top-down models driven by arbitrary growth rates, you're failing to capture the details and key drivers that are not only important to building a proper forecast, but to understanding the variance between actuals vs. forecast.

How many times have you heard a variance explanation for revenue stating that the variance was due to a lower-than-forecasted growth rate? This answer can be frustrating, as it doesn't provide you with actionable information. It's much more valuable to know why the growth rate was lower than forecast. And a detailed model can help you understand drivers as well as all the other key aspects of your business.

In this whitepaper, we'll cover recommendations and best practices for building subscription-based forecast models.



Track Detailed KPIs

KPIs are not only useful for measuring current performance, but also predicting future performance and forecasting future demand. KPIs allow you to identify what's driving certain results and adjusting when necessary. They are also helpful when doing periodic re-forecasts—as future-month forecasts may need to be adjusted depending on how actuals are tracking to forecast.

Let's cover the subscription-based KPIs that every company should be tracking:

Monthly Recurring Revenue (MRR)

A representation of the dependable revenue the company can bank on from month to month, MRR is simply the number of customers multiplied by the monthly rate they pay. This can also be looked at for new customers only. This KPI provides a near-term indication of company health and is also an input into other key metrics (see below).

Average Order Value (AOV)

For companies with various product offerings or tiers, it isn't always apparent how much the average customer is spending. AOV may also vary geographically or by sales channel, and this KPI can thus provide insight into the performance of various market segments. AOV is calculated by dividing MRR by the number of customers.

Customer Acquisition Costs (CAC)

The keys to success in a subscription business are the acquisition and retention of customers. CAC shows how effectively and efficiently your acquisition-focused sales and marketing dollars are being spent. CAC is calculated by dividing total spend on acquisition-focused sales and marketing by the number of new customers for a given time period.

Track Detailed KPIs *(cont'd)*

Churn

Represents the number of customer cancelations as a percentage of total customers for a given time period. From a forecasting standpoint, it's very important to have this figure dialed in, as an understatement in this figure can lead to a significant overstatement of revenue and profitability. An increasing churn rate may also signal an issue with the company's product or an inferiority versus a competing product.

Customer Lifetime Value (LTV)

The amount of revenue the average customer generates over his/her time as a customer of your business. There are a few ways to calculate this figure, but the simplest is by dividing MRR by the churn rate. For businesses with multiple tiers, you'll want to track this at the individual tier level as well. An additional metric would be looking at LTV less CAC to determine the profitability at the customer level.

Why these KPIs?

These particular and widely used KPIs are the essential metrics that help determine the overall health of a subscription-based company:

- Monthly Recurring Revenue
- Average Order Value
- Customer Acquisition Costs
- Churn
- Customer Lifetime Value

Meticulous tracking of these metrics will allow businesses to spot unfavorable trends and, more importantly, determine what is driving those trends. This allows a company to be more agile in taking the necessary actions to minimize the adverse impact on the business.

Forecast via Detailed Revenue Buildup

You should forecast your revenue at the individual channel level (e.g., paid search, email, social) using estimates for key drivers such as CAC, Churn, AOV and projected acquisition-focused marketing spend. This approach allows you to perform detailed attribution analysis by looking at the KPIs listed above by individual channel. It also allows you to pivot marketing dollars to more profitable channels if needed.

Again, while having this information at the consolidated level can be valuable, that won't necessarily answer why trends are happening. For example, if your CAC is continuing to increase, identifying that increase isn't as informative as diagnosing what is driving the increase. If you're tracking CAC across all channels, you might determine the increase occurs across all channels, or you might find that it's driven by an increase in one or two channels. Depending on the case, your response and recommendations will differ. A detailed revenue buildup provides you with the granularity to make this type of determination.

Create a Scenarios Tab With a Toggle Feature

Having the ability to quickly look at the impact on your forecast of changes in key drivers is essential. Too often this process involves changing multiple cells on different tabs, when manipulation should be consolidated into a single tab. By having a dedicated tab that lists the key drivers for multiple scenarios, the user can simply change a single cell that dictates which set of assumptions are running through the model. This structure also allows the user to quickly add scenarios without having to make extensive manual adjustments.

Build a Three-Statement Model

In many cases, particularly in the case of startups, tracking cash is just as—or in some cases more—important than the P&L results. Thus, having a full three-statement model (i.e., P&L, Cash Flow and Balance Sheet) is ideal. Some companies may use a proxy such as EBITDA for their cash forecasts. This approach can potentially result in an inaccurate cash burn estimate, as it fails to consider working capital assumptions as well as any required capex and financing obligations.

Building out a full three-statement model ensures you've captured all these factors and gives you increased confidence in your cash runway.

Include a Detailed Staffing Build Section

This section should show all current staff as well as projected future hires, salary, start date, termination date and any potential pay increases and the date of those increases. Many models take their current staffing costs and assign a growth rate for the purpose of forecasting. This detailed approach provides greater accuracy in forecasting, and it also assists in the variance analysis process by allowing company leaders to assign variance figures to specific positions. Be sure to include associated costs such as health care, 401k, and employee perks that will add to the overall employee expense.

Prioritize Forecast Model Optimization

A detailed model with these features can be critical, whether you're raising money for your business or developing an operational plan to determine your cash runway and path to profitability. However, the creation of advanced models is time consuming and often quite complex. Many companies don't have inhouse expertise capable of adding modeling on top of their day-to-day duties. Thus, forecast model creation and optimization projects tend to move to the backburner in favor of more urgent internal initiatives.

NEED SUPPORT?

BRING IN THE EXPERTS.

8020 Consulting's team of 90+ consultants has been assembled to support Southern California businesses with project-based or interim finance and accounting talent. Our SaaS team features consultants with experience in investment banking, financial planning and analysis and working with subscription-based companies.

To leverage our extensive financial modeling experience in building your company's forecast model, reach out to us. We can help you improve your forecasting while your internal team focuses its time on executing the immediate needs of the day-to-day.

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