

# Tackling SaaS Churn

White Paper

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# Executive Summary



As Cloud Computing is gradually transforming the core nature of the software business model, the software-as-a-service (SaaS) companies require new metrics to measure their success. Indicators such as customer lifetime value (CLV), monthly recurring revenue (MRR), and the customer acquisition cost (CAC) ratios are rapidly becoming well known and frequently used metrics.

However, it's the less prominent levers that often separate the market leaders from followers. In a recurring revenue business, understanding where to pick up an extra half percentage point each month can lead to double digit gains in annualized revenue. Missing these indicators, on the other hand, can negatively affect a company's growth on the long run and lower its overall valuation.

SaaS firms often suffer from customer churn. Churn rates of 1% to 5% are common, sometimes they can escalate to whopping 15%-20%. This can mean significant losses in yearly revenue. While a 100% customer churn is not practical or even desirable, top organizations in service industries such as mobile operators or internet service providers enjoy much lower churn rates of 0.3% to 0.6%, which creates additional

opportunities to drive referrals, increased sales, and lower CAC. SaaS companies operating at this level of performance could increase profitability per customer six fold.

This white paper outlines current challenges in churn management, describes leading practices for developing a knowledge of true churn causes and priorities, and covers the organizational challenges that must be overcome to eliminate the root causes of churn and increase profitability as a result. It is based on a collection of best practices of top-performing service providers in areas including planning, development, marketing, sales, operations and customer care. Adopting these practices will help you retain more customers, boost revenue, and create a sustainable competitive advantage.



# Introduction



There are certain advantages and disadvantages in the general shift to subscription business model that more software companies are currently making. The advantages of this shift is that revenues have become much more predictable and stable. The software companies now have more available data than ever before about their customers. Moreover, adding and supporting application features and functionality is much easier to do in Cloud based products than in their on-premise counterparts.

The disadvantages, on the other hand, are that companies have to keep re-selling the sale in order to retain these customers over time. The valuable customer data is normally scattered all over the company and is therefore not easily accessible.

Another challenge of subscription business is that competition doesn't stand still and is rapidly adopting the same features to their applications too.

The meaning is clear. In the SaaS/Cloud business model, what is really being sold, is a relationship rather than technological features and functions, and keeping that relationship profitably going for as long as possible is the core issue for long-term success as a SaaS company.



# The COST of Churn



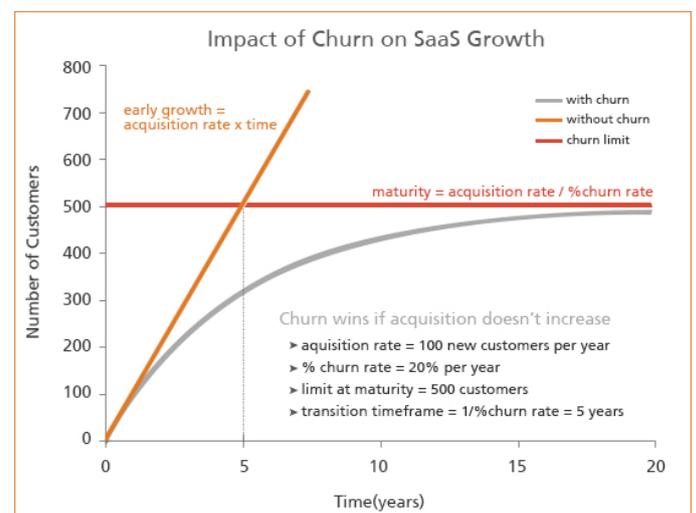
In the start-up phase, it is very difficult for SaaS companies to assess the real impact of churn as they lack the longitudinal data. In their “land-grab” phases, SaaS companies normally do not have time and money to worry about attrition. It makes sense for the first year or two after the product was launched. Especially attrition is overlooked when the service is offered to customers on a yearly agreement basis; the company enjoys growing profits and customer base. However when the first contracts start to expire, the churn starts to affect Monthly Recurring Revenue (MRR) values.

Surprisingly, there is no standard calculation for customer churn. Many companies use different measurement windows, include or exclude customers that join or leave during the period, separate the data by type of churn (voluntary or involuntary), use recurring revenue instead of number of subscribers, or choose figures with either the beginning, ending or average customer count over the term. In order to keep this paper as simple, we will therefore define:

$$\text{Annual Churn Rate} = \frac{\text{No. of Customers who Left by Year End}}{\text{No. of Customers at Beginning of Year}}$$

This definition excludes any customers added during the year. For example, a SaaS company has 1,000 customers on January 1, and of these, 200 cancelled their subscriptions by December 31, making the annual churn 20% (20/1,000). The average monthly churn is then approximately 1.7% (20%/12). Of course companies may favor other calculations, for other purposes, but gross, relative performance is sufficient for the analysis performed for this white paper.

Churn is a cumulative problem. The income lost during a year continues to be lost next year and the year after.



As a SaaS company grows, absolute churn increases with the total number of existing customers and will limit growth if new customers are not added at a faster and faster rate.

Source: Chaotic Flow





SaaS Capital, a provider of debt-based growth capital for SaaS companies, provides an excellent example:

Two SaaS companies sell only software subscriptions; no other income sources are included. Both sign 10 new subscriptions per month at \$1,000.00 each. Both spend \$120,000 per month on sales and marketing to acquire those relationships (CAC). The only difference between them is that one has a customer retention rate of 95%, and the other one only 80%. At the end of 5 years, the difference in bottom-line company valuation between the two was \$15 million. Along the way, the company with 95% retention rate also has increased revenues to work with up to \$24,000 per month.

From the above example it can be concluded that company profitability is closely tied with per-customer profitability when sales and marketing costs are included: customer profitability = CLV - CAC (Customer acquisition costs). Naturally, if CLV is equal to or less than CAC, the company has a problem. The Average Lifetime of a Customer is equal to  $1/\text{Churn}$ , so cutting churn rate in half doubles CLV and per-customer profitability. Acknowledging this leads to a stunning conclusion: even small

reductions in churn can make a big difference.

## Customer Lifetime Value (CLTV) formula:

$$CLTV = \text{Average Lifetime of a Customer} \times (MRR - \text{Monthly Cost to Serve})$$

To complete the picture, not all churn is bad. Some customers buy a product only to see it doesn't fit their needs. Others consume a disproportionate share of support resources, and therefore, are too costly to serve. Some have unrealistic demands, others are abusive or try to damage a company's reputation, consequently consuming more marketing resources. Bottom line is, a small percentage of attrition will always be present.



# CAUSES of Churn



## 1. A hidden trap

A hidden trap many SaaS companies get caught in is over reliance on churn predictive modelling. Desperate to stop the churn wave and plunging profits, the solution seems fairly obvious: by leveraging the rich customer data scattered throughout the organization, the companies should be able to predict if the customer is most likely to churn in the near term and then create activities to prevent them from churning. It's an appealing option, the market is full of relatively inexpensive solutions and experts that build solid churn models in only weeks or months. Any statistician can confirm that the model performs as promised - predicting who is likely to abandon the service.

Many companies have created Customer Success Management functions assigned to enrich the user experience. They deliver a positive customer onboarding experience. Equipped with a special toolkit full of loyalty programs they rush to the most at-risk customers to save them from churning.

These are good steps, but they are not enough. It can be compared with a doctor who is treating only those patients, who are about to die, but without knowing which diseases to treat.

It is far more efficient to investigate why the customers are leaving. Once the root cause becomes known, targeting at-risk customers with the right offers can be accomplished with maximum efficiency.





## 2. Identifying the root causes

Customer attrition observed in the SaaS business can be associated with many factors. Service Excellence Partners, a business consulting firm specializing in SaaS companies, studied customer loyalty in many different companies. They found that customer churn is often associated with failure of the supplier to deliver certain benefit types:

**1 IMPLICIT.** The customer learns the service is missing a basic feature or lacks performance they normally take for granted. For example: an internet service provider that drops connection or a cleaning service that leaves dirt behind. When obvious expectations go unmet, customers have the greatest dissatisfaction and are most likely to churn.

**2 EXPLICIT.** The customer realizes a specific promise in the sales process regarding features performance, or cost is not being kept. For example: a bill for the service is much higher than quoted, an internet service provider doesn't deliver the promised connection speed or the coffee at the new cafe is not as good as they were promised. The customer may never return if the issue is severe and the dissatisfaction is high enough. If a competitor promises comparable

benefits, and changing providers is painless and cheap, potential for churn grows.

**3 EXPERIENTIAL.** The customer discovers a mediocre ongoing relationship with the supplier. For example: a customer care representative was unhelpful, a sales representative who only reaches out when selling something or a rude waiter. Even though the service meets specifications, customers churn when they feel ignored, devalued, or treated unfairly by the company or its employees.

At this point the conclusion is fairly easy; customer retention, requires involvement from top management and often changes in the way the company operates. All functions in development, marketing, sales and service contribute to customer experience, and consequently renewals, up-sells, and loyalty.

The next chapter will describe the most efficient methods in churn prevention.



# Best PRACTICES in churn prevention



## 1. Setting Priorities

Going back to the idea that not all churn is bad; it is important to prioritize targets according to the most profitable customers during the initial phase of the development of a churn prevention strategy. To identify these customers, the top management should ask themselves the following questions:



- Who are these customers?
- How valuable is each segment?
- What is the Monthly Cost to Serve (MCS) for that customer?

To make that initial sale, a company needs to know quite a lot about its prospect customer.



- What were their business needs and requirements?
- Who were the decision makers and influencers?
- What were the timetable and budget

All of this knowledge and more make the signature on the first contract possible. To get the renewal signatures, however, a company will have to keep this data up-to-date and to add to it. A very good way to complete the available data is by conducting on-boarding and exit

surveys. Account management and support departments can prove very useful in supplying the necessary data for each segment, as these departments are constantly in direct contact with the customers and their challenges. Moreover, recording calls and other interactions with the customers can help identify quality issues of these departments.

By scoring each segment accordingly, sales and marketing teams can then use this data to direct their outbound and inbound efforts based on top-level strategic priorities.





## 2. Embrace the individual

One of the major benefits of the SaaS and cloud computing trend is the ease with which companies can purchase, implement and consume services, at individual price points far less than their on-premise counterparts. This 'consumerization of the enterprise' also allows the individuals to purchase enterprise SaaS services for themselves, their work group or even company as a whole, without going through a centralized purchasing department.

The critical challenge of this aspect is ensuring that people can pay online for the service with automatic payments, especially in subscription or recurring billing environments. These automatic payment methods include credit and debit cards, e-wallet services, ACH, PayPal. An immediate direct benefit of accepting automated online payments against relying exclusively on invoices is radically reducing Days Sales Outstanding (DSO) and significantly improving cash flow.

## 3. Tailor pricing and packaging according to customer usage

Regardless of the business model, measuring usage and engagement is a great mechanism to validate the pricing models.



Are the heaviest users underpaying or overpaying relative to the infrequent users?

Are the heaviest users provided with cross-sell/up-sell opportunities more frequently than the light users?

Is the support team enabled to engage in sales activities based on customer interaction?

## 4. Manage upgrade segmentation

Pricing and packaging are not only the matters that play an important part during the onboarding phase, but also when the customer is frequently using the service that counts. How the company segments customers with respect to upgrades and when the customers are pitched are both important. For example, customers who previously churned shouldn't be pitched, the offers should be pitched to customers who are already beyond the Average Customer Lifetime Value (ACLV).





## 5. Align customer acquisition with long-term customer lives

As a SaaS business is all about recurring revenues, a SaaS company should focus its business activities around crafting long-term customer lives. However, most companies focus their customer acquisition efforts around conversion rate optimization, especially if they offer free trial or a freemium offering. They then rate their various marketing campaigns and activities around that metric (for example: product demos or webinars drove the highest conversions, so they direct money into developing additional webinars).

To reach to a more relevant KPI, it is necessary to understand which marketing activity lead to the longest customer lives. Once the marketing teams segments the cohorts by customer life and marketing campaign, they can then optimize for those acquisition activities that drive the biggest gains in overall revenue, not just conversion rates.

## 6. Better subscription handling

As many SaaS companies rely on an ecommerce providers' services to handle recurring payments and billing, many SaaS businesses face significant

amount of churn every month, even though these customers want to remain subscribers.

Often the reasons for this involuntary type of churn can be errors in payment failure. A subscriber's card can fail for a number of reasons - from failures in the card association network, to the subscriber being temporarily over their credit limit. How these involuntary churns are managed can mean hundreds of thousands in additional revenue to the SaaS business, and few businesses understand the payment networks well enough to optimize this retention aspect on an on-going basis.

Because the payment provider plays an important part during the onboarding and renewal phases, it's crucial to identify a platform that offers the necessary amount of individual care and attention to each of their company's clients by offering the tools that deliver flexibility, tailoring subscriptions around product requirements without system capability restrictions. Another aspect to consider would be if the provider is using cascading payment gateways to ensure recurring payment success.



# Conclusion



The conclusion is obvious; churn is risk and the best way to deal with risk is by avoiding it altogether. The churn prevention shouldn't start only when the effects of attrition start to show. This prevention should be the user experience delivered by the employees of the whole company.

The benefit of the cloud computing is the wealth of data that has never been available ever before. By performing data-mining on an ongoing basis and extracting valuable insights from it, SaaS companies can identify and efficiently address the potential causes of churn that can potentially cripple the company. Since most churn reduction

initiatives require changes and support across several functional areas, hard decisions will need to be made. It is essential that a clear and compelling set of facts get established that will focus and drive successful churn management initiatives.

Better results come from better strategies. By leveraging the insights gained from data, the company can implement better approaches to reduce churn. By adapting at least some of the practices described in this paper and making the improvement habitual, SaaS firms can retain more customers, generate more sales through referrals, and dramatically improve profitability.



# About PayPro Global



PayPro Global provides flexible e-commerce solutions that enable software and SaaS companies of all sizes to build and grow their online businesses, reduce costs, minimize risks and enter new markets. The company's offer includes flexible and automated recurring subscription billing, real-time business reporting, 24/7 customer support, fully customizable checkout, assistance in web design, sales and marketing.

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