Unit Economics

OVERVIEW

You may be wondering how to best explain the success of your company in a financially quantifiable manner that speaks to the interests of investors. Unit economics is the answer to that! This discipline will need to be among your best friends and will prove instrumental in explaining the financial condition of your products/services and sales success on an outflow/inflow per unit basis.

UNIT

As a company, you are always selling some ‘thing’ whether that ‘thing’ be a product or service. The unit is that ‘thing’ that you offer to customers. If you are a beverage company, the unit may be a bottle of your product. If you are a SaaS company, your unit may be a subscription. If you are an enterprise software company, your unit may be a software suite. Regardless of the type of company, you have to define and identify what your unit is before you can delve in to the economics of it. Only then can you narrow your focus on the costs and other metrics associated with that ‘thing’ that is driving your business.

CUSTOMER ACQUISITION COSTS (CAC)

This is the ratio of the amount of money spent to land a customer to the number of customers that actually purchase units in a given time period (e.g. a month, year, etc.). This ratio does not include customers who are receiving your unit for free. Keep in mind that customer acquisition expenses include the cost of all marketing, public relations, and non-product development efforts as well as the salaries for employees and consultants dedicated to those efforts. It is important that you be honest about this number in order to have a more accurate analysis and to be transparent to investors. Trust that investors will ask. If they sense that you do not have a strong grasp of your acquisition expenses, the reality is that your financial model, scalability, and credibility likely come into question.

CAC = **(Expense of Obtaining Customers)** / **(Number of Actual Customers)**

METHODS TO DECREASE CAC

Now that we know how important CAC is, we know that this expense ideally needs to decrease in order to make the company more attractive. Many of the methods regarding decreasing CAC revolve around marketing and data analytics. Here are some examples below:

FUNNELING

This is an honest valuation of the effectiveness of the different acquisition activities. For the activities that are less effective, little or no more money should go towards those activities. For the activities that are more effective, the converse is true; more money should go to those activities. The idea here is to optimize effective marketing tactics and marketing spend

STRATEGIC PARTNERSHIPS

The establishment of strategic partnerships allows for marketing efforts to still take place but as opposed to having to pay cash, you may exchange services instead. You will likely find success with this method by reaching out to complimentary product/service providers or beneficiaries that use your product and have a strong potential customer base.

CUSTOMER EXPERIENCE

One of the strongest marketing tactics is word-of-mouth marketing. Creating a strong product and reputation are not easy but providing great customer service and support can help accelerate that attribute. Once you have established a strong following, that base will likely spread the word about their positive experience with the product/service and market your product of you; thus, increasing your customer base with minimal increases to acquisition expenses. It is, however, critical that you engage with that base to stimulate their virality of experiences, such as the use of customer reviews, videos, testimonials, etc. through multimedia.

CUSTOMER LIFETIME VALUE (LTV)

This figure predicts the total amount of revenue that a customer will provide you over the time they use your product/service, which is the value of the customer relationship. This forecasting indicator uses industry averages to determine the amount of purchases a customer will make of your product over the industry average relationship span for a customer, then multiplies that frequency by the cost of the goods predicted to be purchased. Proper research should provide you with the industry data to make your LTV analysis sound.

LTV = **(Lifetime Amount of Predicted Unit Purchases) x (Price of Units Purchased)**

LTC AND CAC RELATIONSHIP

At this point, you have both the CAC and LTV. As an efficiency, viability, and scalability metric, investors look at another ratio, LTV:CAC. Piecing the concepts discussed above together, you can surmise that this new ratio gives investors a reference point to determine whether the company’s operations are at a point where the company is worth investing in. If the ratio is too low, investors may deem that the company needs to improve its go-to-market strategy or find more value in the target customer, or both. If the ratio is high, investors may be impressed and attracted to investing. Most investors ideally look for a 3:1 ratio to spot a potentially profitable company, but it all depends on the company and industry.

CHURN RATE

This metric tells you how much business you are losing over a period of time. This is the rate at which customers stop purchasing your unit – also known as customer attrition. Logically, churn rate is very useful in setting revenue goals as it can provide a point of analysis in determining the amount of new revenue that should come in to cover the predicted loss of business from the churn.

Churn rate can be found via the method below:

1) Define a time period (e.g. Jan. 1 - Dec. 31). The time period analyzed should be an amount of time that provides customers with an opportunity to make another purchase of your unit. For example, if you offer monthly subscriptions, you would likely analyze a period of a year as a customer would have multiple opportunities to re-subscribe (purchase a unit) in that time frame as opposed to measuring a month which would not comfortably allow purchasers an opportunity to purchase another unit.)

2) Find the number of customers acquired in this time period.

3) Find the number of customers that did not repeat purchasing the unit (these are the lost customers).

4) Divide the number of lost customers by the number of acquired customers.

5) Multiply that number by 100%.

Churn Rate = **(Number of Lost Customers) / (Number of Acquired Customers) x 100%**

CONCLUSION

Unit economics is the language of scalability and growth. It is important for your company to know its unit economics as well as what is the market standard for its industry's unit economics in order to benchmark where the company is in its life cycle and to also have a realistic expectation as to what investors are looking for.

**Note that the expected and acceptable unit economics benchmarks will vary per product and industry, as well as whether the company is B2B or B2C. Generally speaking, B2B relationships are more difficult to develop with a longer timeline for adoption and higher CAC costs than B2C relationships as businesses take more time to make product decisions, especially since the product/service is generally much more expensive and causes a higher degree of logistical management than a typical consumer product. However, the LTV of a B2B relationship may be astronomical in comparison to that of a B2C relationship as the purchases and relationships generally yield much more revenue. Know your market and reach out to your service provider to obtain the market norms for your company.*

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