Castellum Capital

Essential Growth Metrics for Startups

© Castellum Capital 2023

Scaling efficiently remains a mystery to startups. We're here to solve that.

Tracking growth extends far beyond following your simple revenue growth. There is a wide variety of growth metrics available that will enable you to better understand the drivers behind your business and to paint a better growth story for your company

Accounting Metrics

- These metrics are recognized under the Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS)

- **Includes:**
  - Revenue & Profit
  - Cost of Revenue

Finance Metrics

- These metrics are not included in your financial statement, but are crucial in helping you to manage your firm's growth

- **Includes:**
  - Annual Recurring Revenue (ARR)
  - Gross Revenue Retention
  - Average Revenue
  - Committed ARR
  - Free Cash Flow

Accounting Metrics: Revenue & Profit

Revenue

- Also known as the top line, this is the amount of money the business generates from its core business operation through the sale of goods or services

Gross Profit

- This is the amount of money the business makes after meeting the cost of revenue (cost of producing and delivering the product/service)

Operating Profit

- This is the amount of money the business makes after meeting operational costs, which includes, but not limited to:
  - Rent, payroll, marketing, advertising, utility costs, etc.

Net Profit

- Also known as the bottom line, this is the amount of money the business makes after meeting non-operational costs, including:
  - Income Tax, Interest Expense, etc.

Revenue = Quantity of Product Sold × Price of Product

Gross Profit = Revenue − Cost of Revenue

Operating Profit = Gross Profit − Operational Costs

Net Profit = Operating Profit − Non-operational Costs

© Castellum Capital 2023

Accounting Metrics: Revenue & Profit

Why should you track Revenue & Profit?

For the management team:

- Revenue helps to gauge firm's growth as the revenue generated represents the number of products/services the firm has provided during a certain period
- Profit indicates the firm's long-term survivability and the viability of the business model in bringing value to investors and owners of the firm

Because investors pay attention to this metric:

- Revenue growth is an important factor for consideration. Investors want to know about your revenue growth rate to gauge product market fit and traction
- Investors are willing to overlook profitability in exchange for short term rapid-growth (revenue) because they know the firm is trying to capture market share quickly before their competitors do
- However, even the most seasoned investors will get impatient when the firm stays unprofitable for too long – You should avoid this as much as you can

Accounting Metrics: Cost of Revenue

Cost of Revenue	=	Cost of Goods Sold + Other additional non-specific costs
Cost of goods sold	=	Cost of creating product/service + Cost of delivering product/service

Definition

- Cost of revenue (COR) is the total cost of creating and delivering a product or service to your customer
- Cost of goods sold (COGS) is the direct cost of creating and delivering a product or service to your customer
- For some companies, COR = COGS.
- But for other companies, especially for those that provide services as their main line of business, COR is expanded beyond just COGS, ranging but not limited to:
  - *Application hosting costs – server and cloud fees*
  - *Customer support, personnel training, and account management costs*
  - *Software fees for applications used directly within the product*
  - *Website development and support*
  - *Other indirect expenses related to creating or maintaining the product or service*

© Castellum Capital 2023

Accounting Metrics: Cost of Revenue

Why should you track Cost of Revenue?

- **For both the management team and investors**
  - Cost of revenue is critical as it is a necessary component in calculating the company's gross profit and gross profit margin.
    - *This will enable managers and investors to assess the company's gross profitability*
  - In addition, components in the calculation of cost of revenue for certain companies can more diverse than those in other industries
    - *These additional costs and expense could potentially create significant fluctuations that may shrink (or expand) gross margins*
    - *It is crucial for the firm to be aware of these components so that it can better identify opportunities and weaknesses to maximize gross margins intentionally*

Finance Metrics: Annual Recurring Revenue

Definition

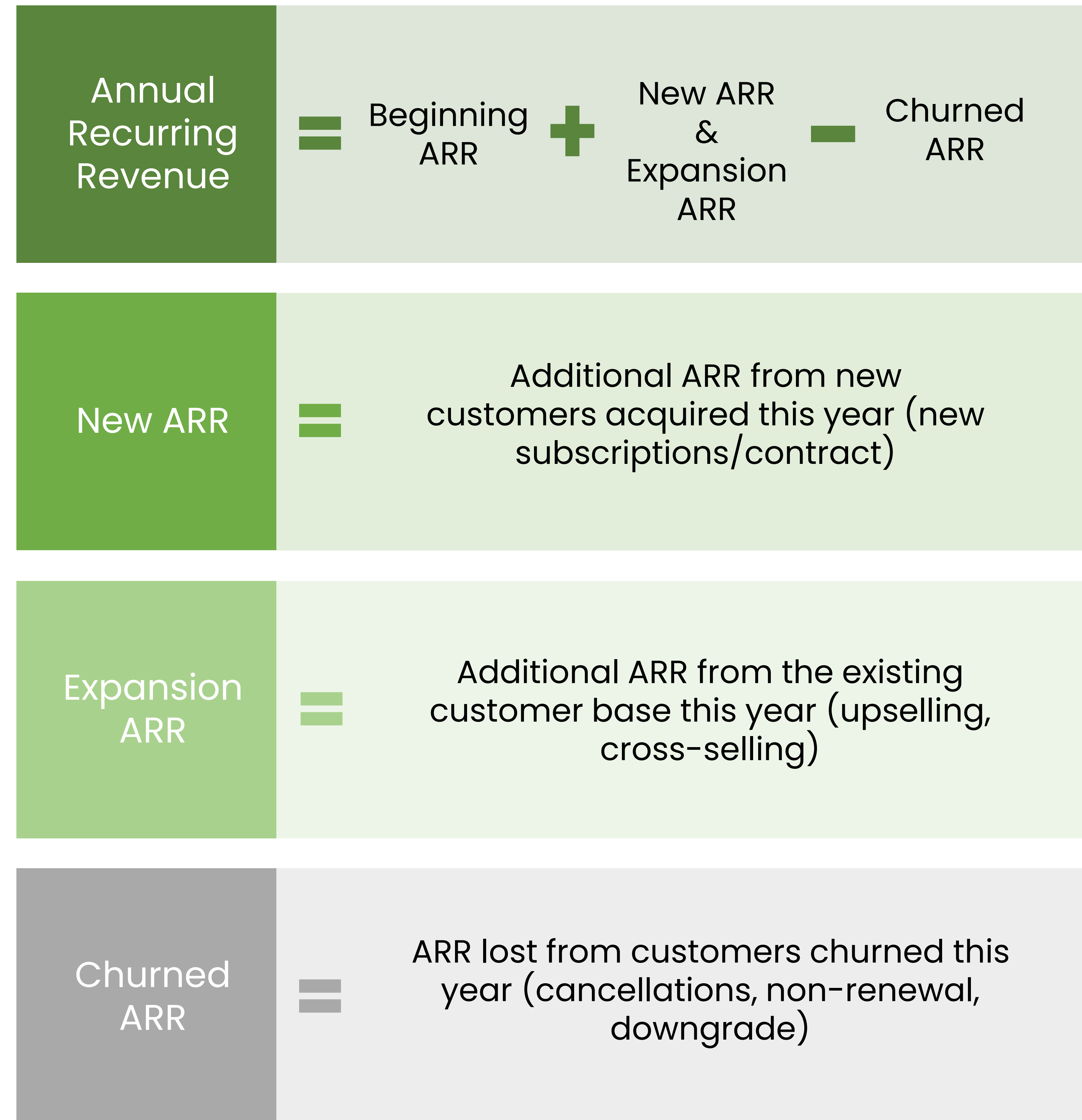
- ARR is an estimate for the predictable revenue generated per year by a company from customers on either a subscription plan or contract

- ARR is not a GAAP or IFRS metrics as it reflects only the recurring revenue component of a company's total revenue

Note

When calculating ARR for auto renewing contracts:

- *For annual contracts = Add into the New ARR directly*
- *For monthly contracts = Multiply by 12 to annualize*
- *For semi-annual contracts = Multiply by 2 to annualize*
- *For contracts that lasts longer than a year = Multiply by 1/(number of years) to annualize*



© Castellum Capital 2023

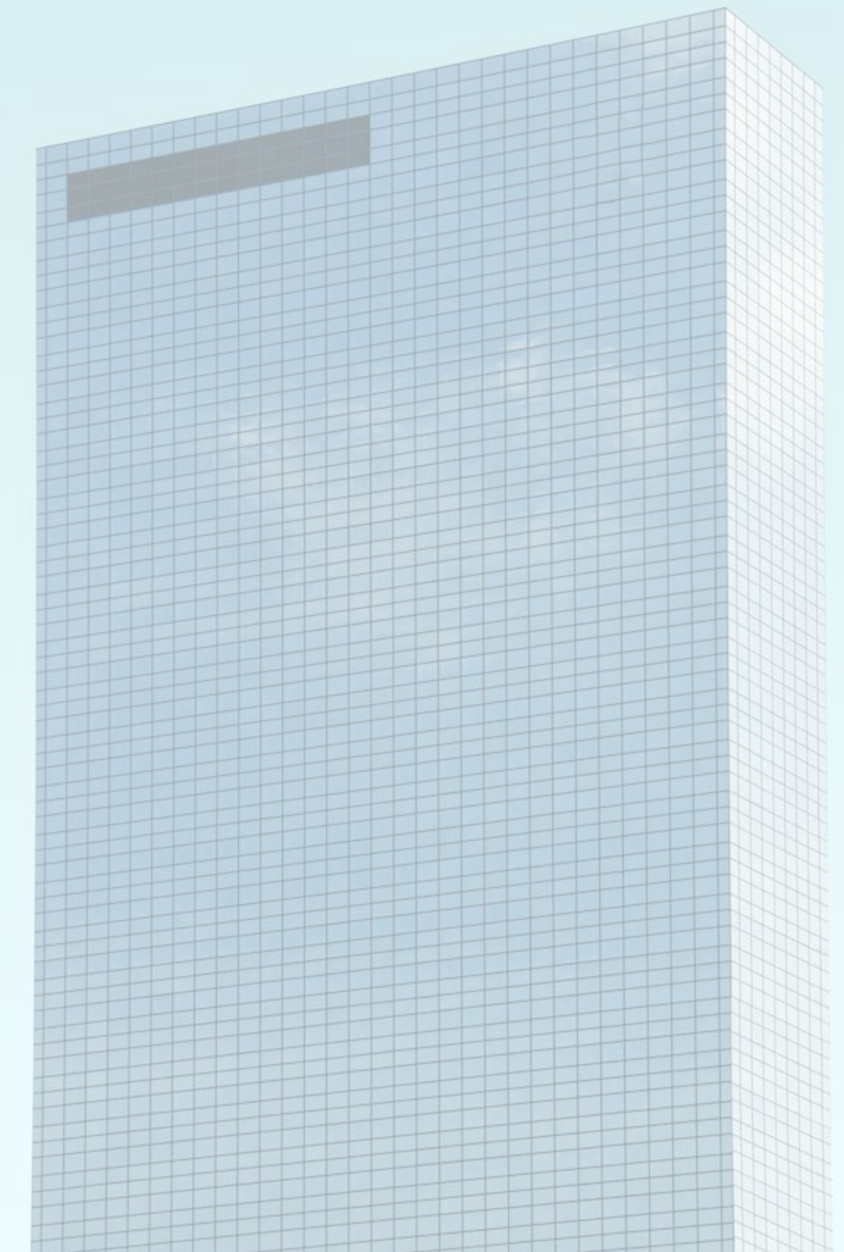
Finance Metrics: Annual Recurring Revenue

Why should you track ARR?

- **For both the management team and investors**
  - ARR is indicative of the long-term viability of the company's business model and revenue predictability
  - It is also useful in understanding the company's growth potential, identifying when to invest money back into the company, and to track product market fit

How to improve ARR?

- **Increase new and expansion ARR**
  - Market towards the ideal customer profile
  - Differentiate revenue streams (Offer different products, services, etc.)
- **Decrease churned ARR**
  - Reduce the number of downgrades, cancellations (Identify potential competitors and devise a suitable pricing strategy, resolve customer pain points, improve customer service)



© Castellum Capital 2023

Finance Metrics: Gross Revenue Retention

$$\text{Gross Revenue Retention} = \frac{\text{Starting ARR} - \text{Churn ARR}}{\text{Starting ARR}}$$

Definition

- Gross Revenue Retention (GRR) refers to the firm's gross dollar retention
- It is a representation the amount of revenue retained from the previous year after factoring churned customers and downgrades in subscriptions

Why should you track GRR?

- **For the management team and investors**
    - GRR is an indicator of the firm's ability to convince customers to renew their business yearly and to not downgrade/stop renewing their existing contract
        - *Diving deeper, a product that can convince customers to keep buying is one that provides value consistently, over a period of significant time*
        - *Value, in this case, is created when the firm's pricing strategy is fair, the customer service is responsive, and reliability is satisfactory*

© Castellum Capital 2023

Finance Metrics: Average Revenue

Definition

- Average revenue measures how much revenue the firm generates on a per unit or customer account basis
- If you sell products in units, use Average Revenue per Unit (ARPU)
- If you sell products via subscriptions, use Average Revenue per Account (ARPA)

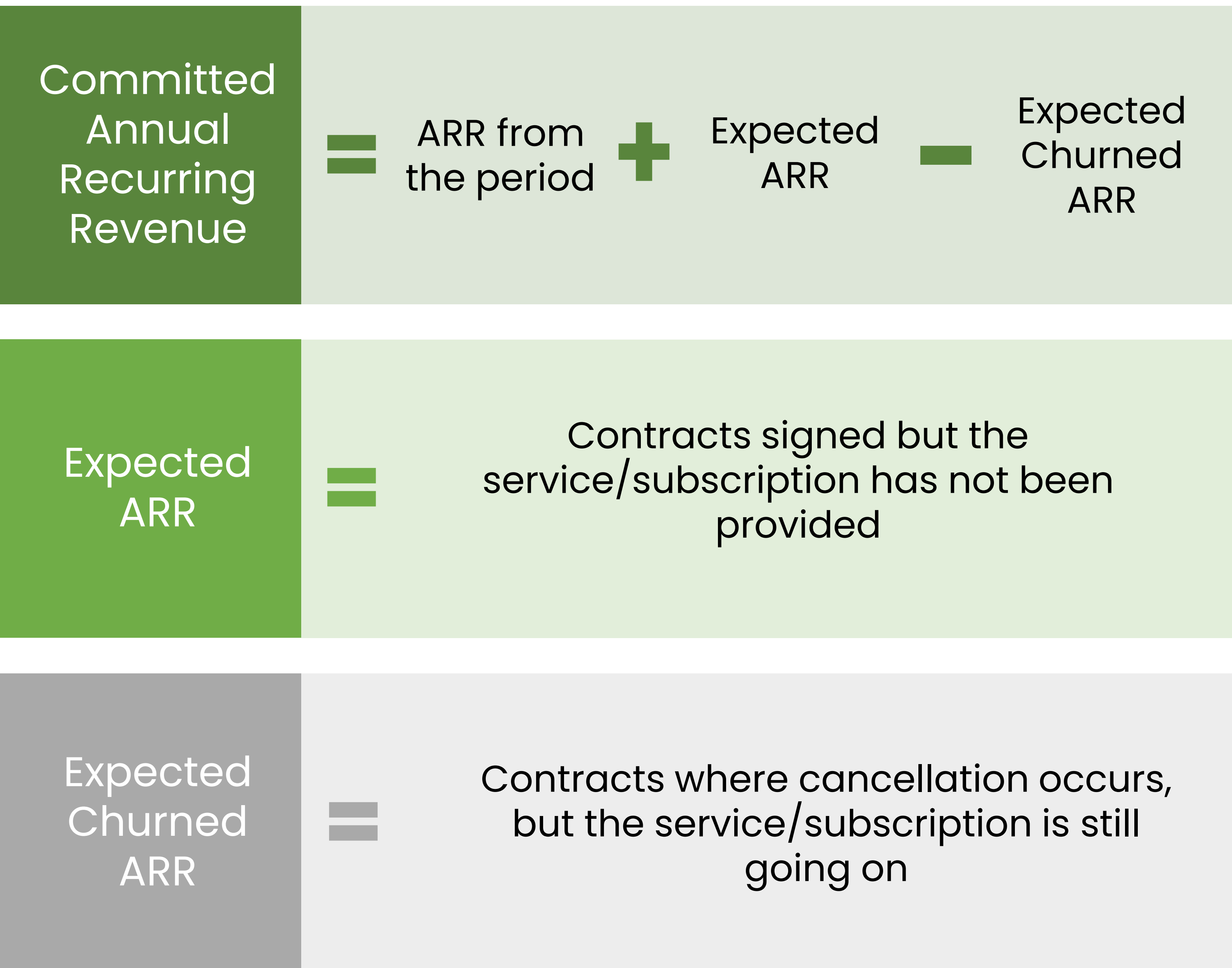
$$\text{Average Revenue per } \textbf{Unit} = \frac{\text{Total revenue generated this period}}{\text{Total number of } \textbf{units} \text{ sold this period}}$$

$$\text{Average Revenue per } \textbf{Account} = \frac{\text{Total revenue generated this period}}{\text{Total number of } \textbf{customer accounts} \text{ in use during this period}}$$

Why should you track Average Revenue?

- **For the management team and investors**
  - Average Revenue can help executives and investors refine their understanding of the firm's revenue generation capability on a unit/customer basis by asking the following questions:
    - *ARPU - How much money is a single product earning?*
    - *ARPA - How much money is the average customer spending on the firm's products?*

Finance Metrics: Committed Annual Recurring Revenue



Definition

- Also known as Contracted Annual Recurring Revenue, CARR is an augmented ARR that accounts for future contracts and churn
- ARR vs CARR:
  - ARR Calculation begins when the contract starts - when the service becomes live/active/being provided
  - CARR Calculation begins when the contract is won - when the contract is signed but the service has not been provided

Why should you track CARR?

- **For the management team and investors:**
  - CARR helps tremendously with revenue forecasting and scenario planning, allowing for more accurate projections then just ARR itself
  - To some extent, some even consider CARR a better indicator of a firm's financial heath than ARR, especially during the early stages where the company can be facing a dry spell in live contracts

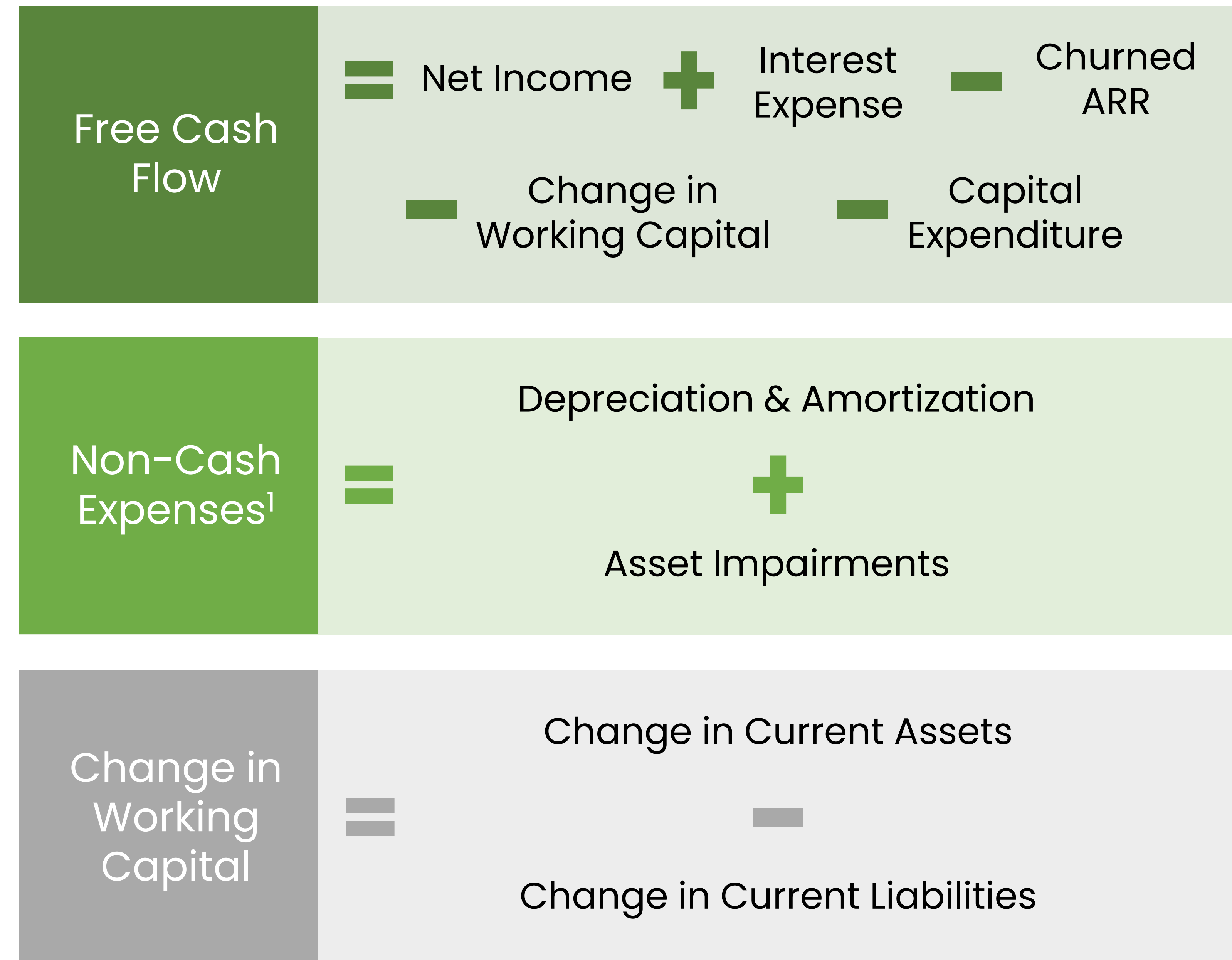
Finance Metrics: Free Cash Flow

Definition

- Free cash flow (FCF) is a representation of the cash a firm generates after accounting for cash outflows to support operations and to maintain its capital assets
- Unlike net income, free cash flow excludes the non-cash expenses of the income statement. It also includes spending on equipment and accounts for changes in working capital

What is a good Free Cash Flow figure?

- Depending on the industry/vertical that the firm is operating in, a healthy FCF would look different under several circumstances
  - *Though, as a rule of thumb, a good FCF margin (FCF divided by total Revenue) for any company would lie between 20% to 25%*



[1]Non-Cash Expenses can include other forms of accounting expense that does not involve a cash payment. It is not limited solely to Depreciation & Amortization and Asset Impairments

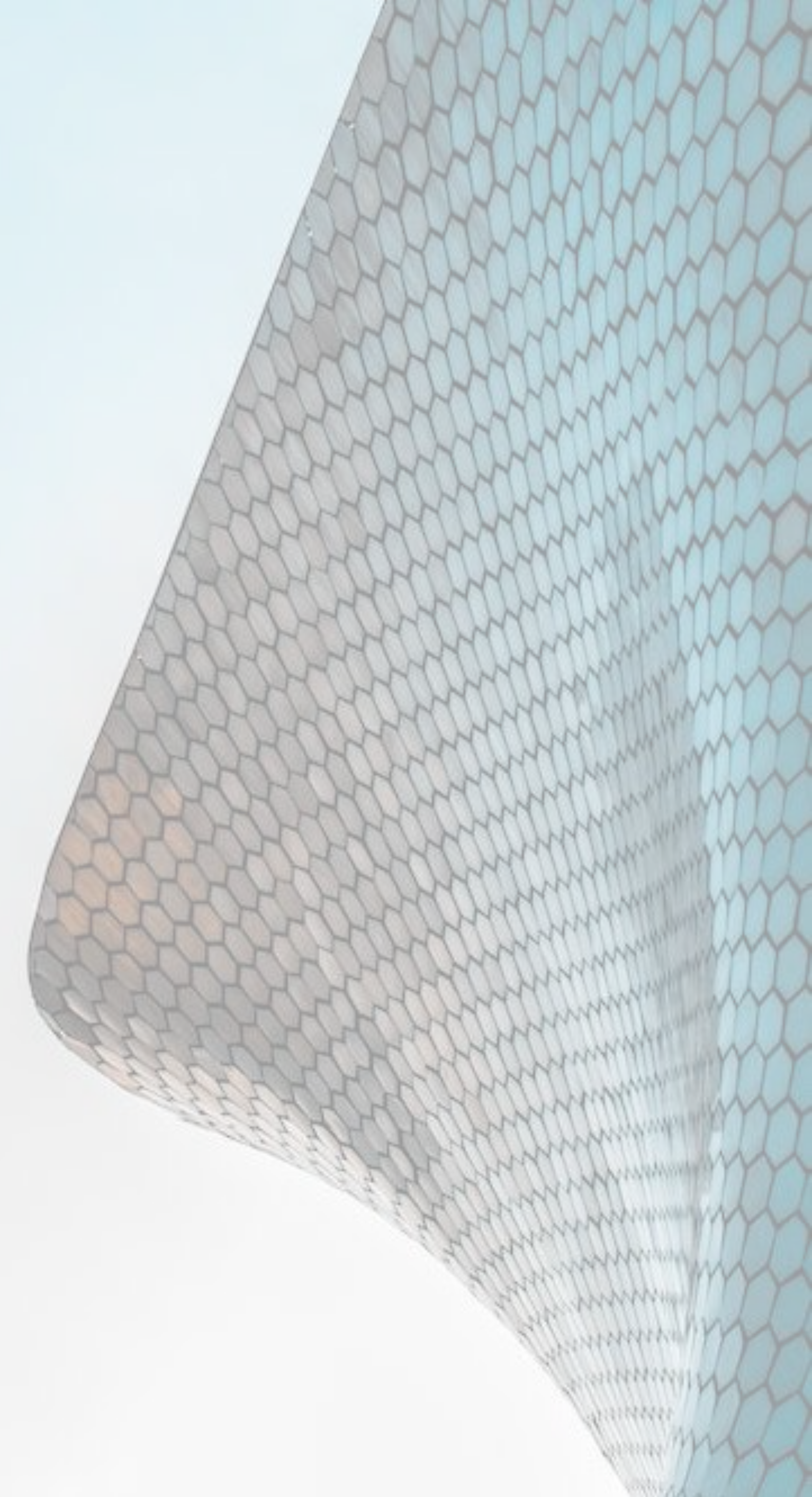
© Castellum Capital 2023

Finance Metrics: Free Cash Flow

Why should you track Free Cash Flow?

- **For the management team:**
  - Free Cash Flow is critical as an indicator of viability of certain re-investment decisions. This includes:
    - *Can the firm invest into R&D to develop new products?*
    - *Can the firm invest in expanding into new markets?*
    - *Can the firm buy back stock or pay dividends?*
    - *Can the firm afford the acquisition of a subsidiary?*

- **Because investors pay attention to this metric:**
  - Free Cash Flow is a good indicator of overall business health in terms of overall profitability
  - It also shows the actual amount of money that can be distributed back to investors in a feasible manner



Castellum Capital

Contact

am@castellum.capital

7 Temasek Boulevard #12-07
Suntec Tower One Singapore

Disclaimer

This has been prepared with public information and solely for marketing purposes. Unless Castellum Capital provides express prior written consent, no part of this report should be reproduced, distributed or communicated to any third party. Castellum Capital does not accept any liability if the information shown is not accurate, nor to any third party in respect of this report