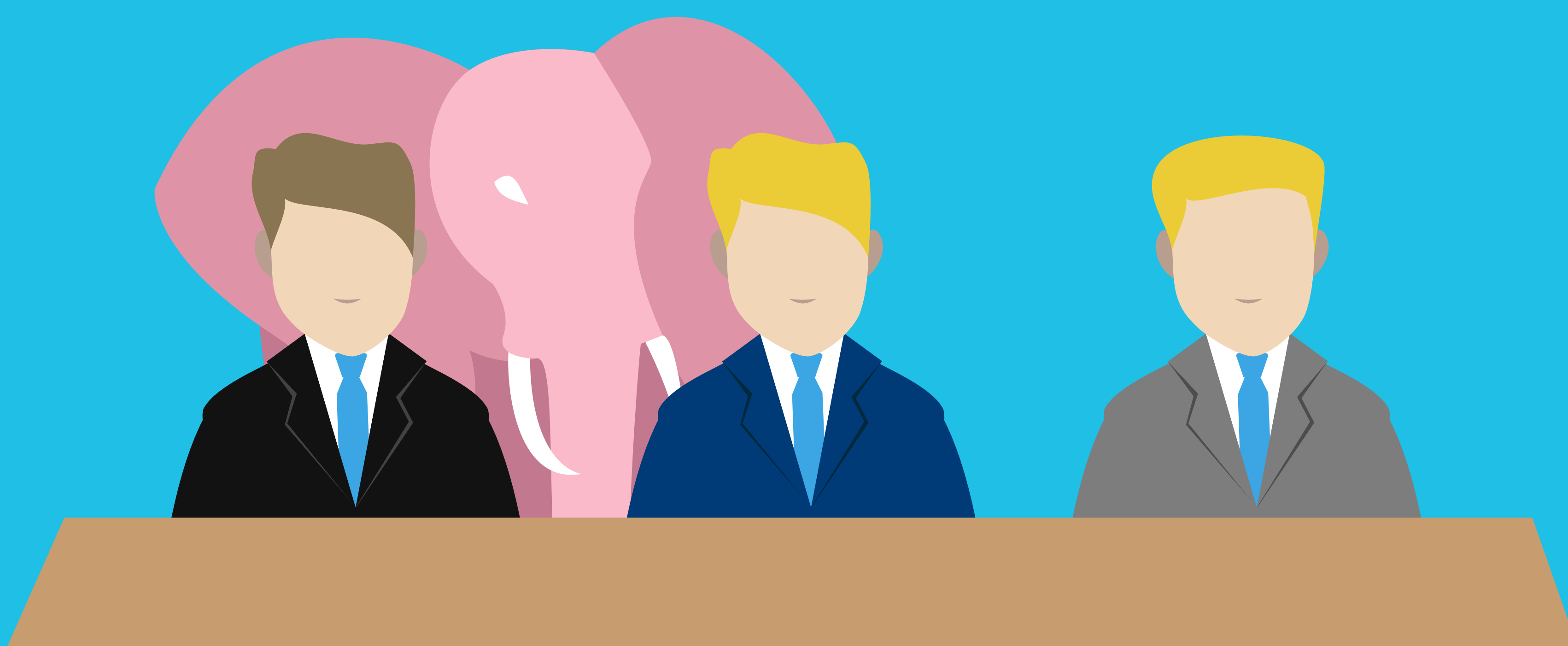
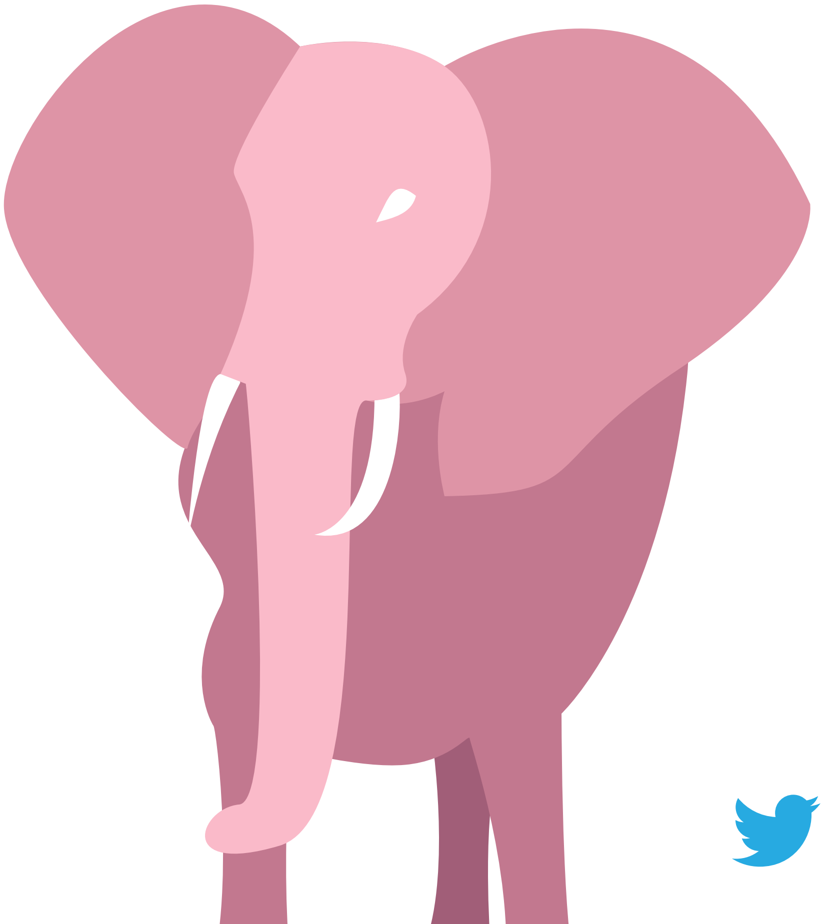
gainsight™

The Executive Guide to Churn

(The Elephant in the Room)



INTRODUCTION



INTRODUCTION

Imagine this executive meeting

YOU
We're now going to talk about sales.

CEO
How are sales going?

YOU
Great.

CEO
Okay - I'll take your word for it - moving on…

Does that ever happen?

Instead, you are likely prepared in every executive meeting with a litany of questions to ask about sales. Are reps hitting quota? Why are we losing deals? What's the pipeline looking like? Is it improving? Can someone please tell me how we'll improve sales?

As an executive, you realize your company's value depends on growth – and you've grown to learn the important questions to ask. But if your company has a business model (SaaS, pay-per-use, pay-per-transaction, cloud, etc.) where your customer pays you over time, your growth comes from your new and existing customers. Making more money from your existing customers is the heart of "Customer Success Management." And as you grow, revenue from existing customers becomes a larger and larger part of your company's economic value.

INTRODUCTION

To use a simple airplane analogy, if new sales is the speed of your plane with no wind, churn is your headwind and up-sell is your tailwind. Take the three of them together to determine how fast you're really flying.

David Skok from Matrix Partners created a simple graphic to illustrate this point:

Net New MRR/ACV =

New MRR/ACV
(New Customers)

+

Expansion MRR/ACV
(Existing Customers)

-

Churned MRR/ACV
(Lost Customers)

INTRODUCTION

But how big of a difference is 80% retention versus 95% retention, you might ask? Analyst Mikael Blaisdell has come up with a powerful example where the ***higher 95% retention rate can literally double the valuation of the company:***

> "Let's consider the example of two SaaS companies, each adding customers at the steady rate of 10 per month, with each of their customers paying $1K per month. The customer acquisition cost (CAC) is assumed to be $12K each, or the cost of 12 months' subscription. One company takes churn very seriously from the beginning, and maintains a 95% retention rate. The other company only manages an 80% retention rate.
>
> Five years later, the 95% company has acquired 600 customers and only lost 30. Their run rate is $6.3 million, and the estimated valuation of the business is $28.7 million. Things do not look so good for the 80% company. They acquired the same number of customers, but lost 120. Their run rate is $4.5 million, and the estimated value of their company is only $13.7 million — a difference of about $15 million in valuation plus the difference in revenues over those five years."

INTRODUCTION

FINALLY, companies that control churn and drive up-sell are able to achieve higher customer lifetime values and therefore are economically able to invest more in customer acquisition.

> This means they can capture more market share over time.

In your executive meetings, when you talk about new sales, you likely inspect:

- **Past:** What were bookings in the last period? (By rep, region, product, etc.)
- **Present:** How do we compare to other companies in growth and share?
- **Future:** What do our leads and pipeline indicate about future bookings?

In this paper, we'll talk about how you can apply the same framework to measure revenue from existing customers:

- **Past:** What revenue are we losing from churn and gaining from up-sell?
- **Present:** How do we stack up to other companies?
- **Future:** What does the health of our customers tell us about the future?

PAST

MEASURING CUSTOMER SUCCESS

TO START, you need to define a consistent set of metrics by which to measure Customer Success as an executive. This area is more complicated than it should be because many public companies use the most aggressive calculation of customer retention possible and hence everyone seems to have a 90%+ retention rate. Your job is to make sure everyone looks at the raw, intellectually honest facts of the business - good and bad.

You should be wrestling with questions like:

- Should we look at churn in terms of dollars lost or customers lost?
- When we think about churn rate, do we include:
    - The negative impact of price reductions
    - The negative impact of renewals with lower dollar amounts or discounts
    - The positive impact of renewals with up-sells
- The positive impact of price increases
- Should we measure churn rate as a percentage of total dollars / customers or dollars / customers that were eligible for renewal?
- How do we think about the churn we can control versus the churn that's out of our control (e.g., customer goes out of business or gets acquired)?
- Can we disambiguate churn rate from newer customers versus older ones?

We surveyed a panel of more than 100 subscription businesses and found:

- 63%+ include down-sells and downgrades in churn numbers
- 58%+ include upgrades, cross-sells and up-sells in churn numbers, though we recommend tracking these separately from churn numbers for internal purposes
- 46% track churn on both a customer and a dollars basis, while 23% track only by dollars and 26% only by customers (the remainder did not respond)

THE FIVE FORCES IN CUSTOMER SUCCESS REVIEW

Our recommendation is to track these 5 critical metrics as an executive:

Metric	How to Calculate	What it Means
Customer Success Magic Number	[ARR/MRR of customers renewed in period + ARR/MRR of up-sells in period] / [Total cost of Customer Success team + Customer Support team]	Like the SaaS sales magic number measures the impact of sales and marketing spend on new bookings, how much of an impact is your Customer Success effort having on revenue retention and up-sell? You'd like to see this number be above 5.0 in most companies.
Customer Success Batting Average	[# of customers renewed in period] / [# of customers eligible for renewal in period]	Are customers voting with their signature on the value of our product or service?
Customer Success Headwind	[ARR/MRR* of churned customers and ARR/MRR decreases] / [Beginning of period ARR/MRR]	How much drag will we have on growth from customers? If this number is significantly more than 20%-30% per year, sustainable growth will be tough.
Customer Success Tailwind	[ARR/MRR of up-sell and price increases] / [Beginning of period ARR/MRR]	How much acceleration will we have to growth from customers? Best-in-class companies generate upwards of 10% up-sell per year on a dollars basis.
Net Revenue Retention	[Beginning of period ARR/MRR + ARR/MRR of up-sell and price increases - ARR/MRR of churn and price decreases] / [Beginning of period ARR/MRR]	What's the net dollar impact from Customer Success to growth? Best-in-class companies are greater than 100% here and ideally greater than 110%.

* ARR = Annual Recurring Revenue (total annualized recurring revenue as of a period);
MRR = Monthly Recurring Revenue

OTHER METRICS TO TRACK IN LARGER ORGANIZATIONS

As your organization scales, you should also track:

- Net Revenue Retention by Region, Product, Vertical and Customer Size: This will help you isolate where churn issues are most prevalent in your business.
- Churn by Reason: By surveying churned customers after the fact and/or asking your staff to identify the reason for potential churn upfront, you will be able to diagnose the root cause of churn issues.
- Top Churns and Up-Sells: As a team, you should review these just like you review top bookings.
- Cohorts: Review churn rates based upon the start date of the contract or other factors to determine how churn and Customer Success are evolving in your business.

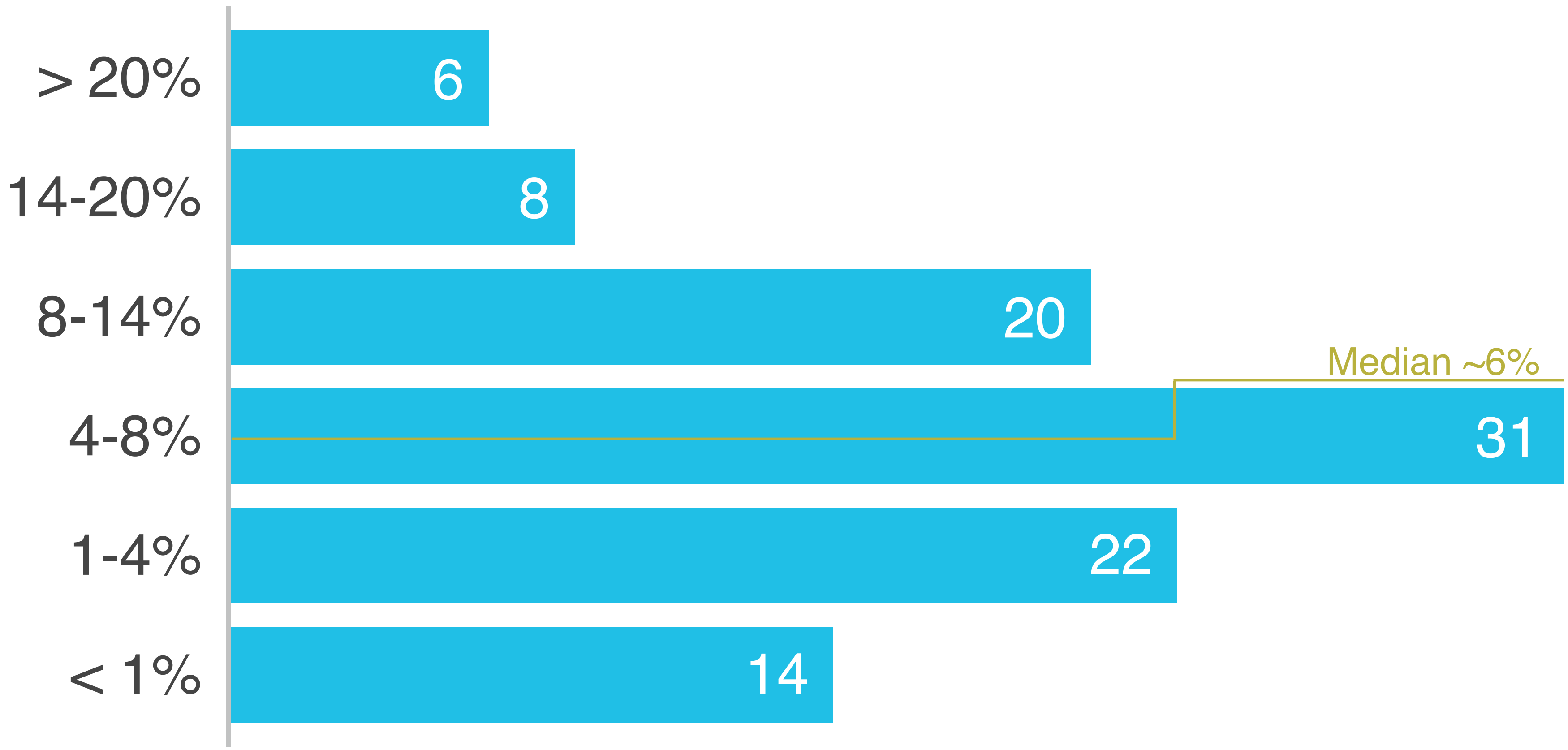
For more advanced discussion of cancellation metrics, check out this blog.

PRESENT

COMPARING CUSTOMER SUCCESS

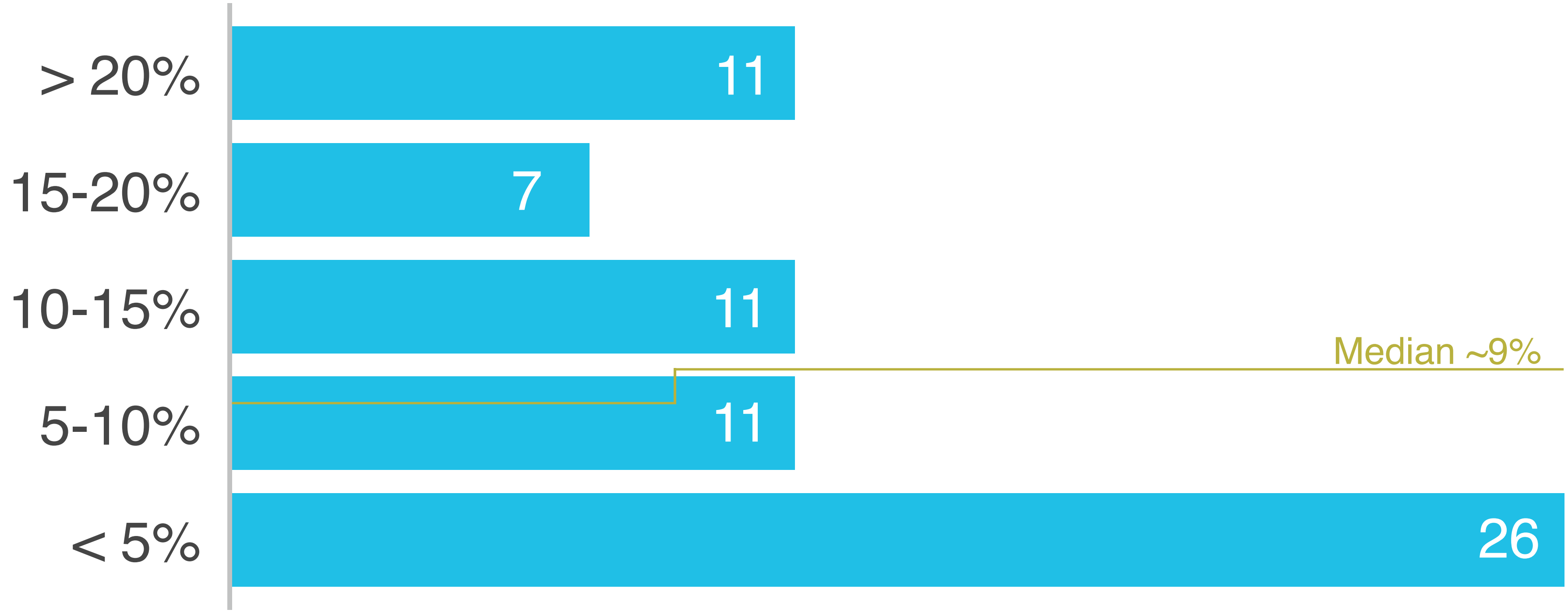
ONCE you have a handle on your metrics, the natural question is how do you stand versus other companies and what do you do about it?

On average, churn rates vary as you might expect. In our survey of 100+ companies, we found median churn rates tend to be in the high single digits:



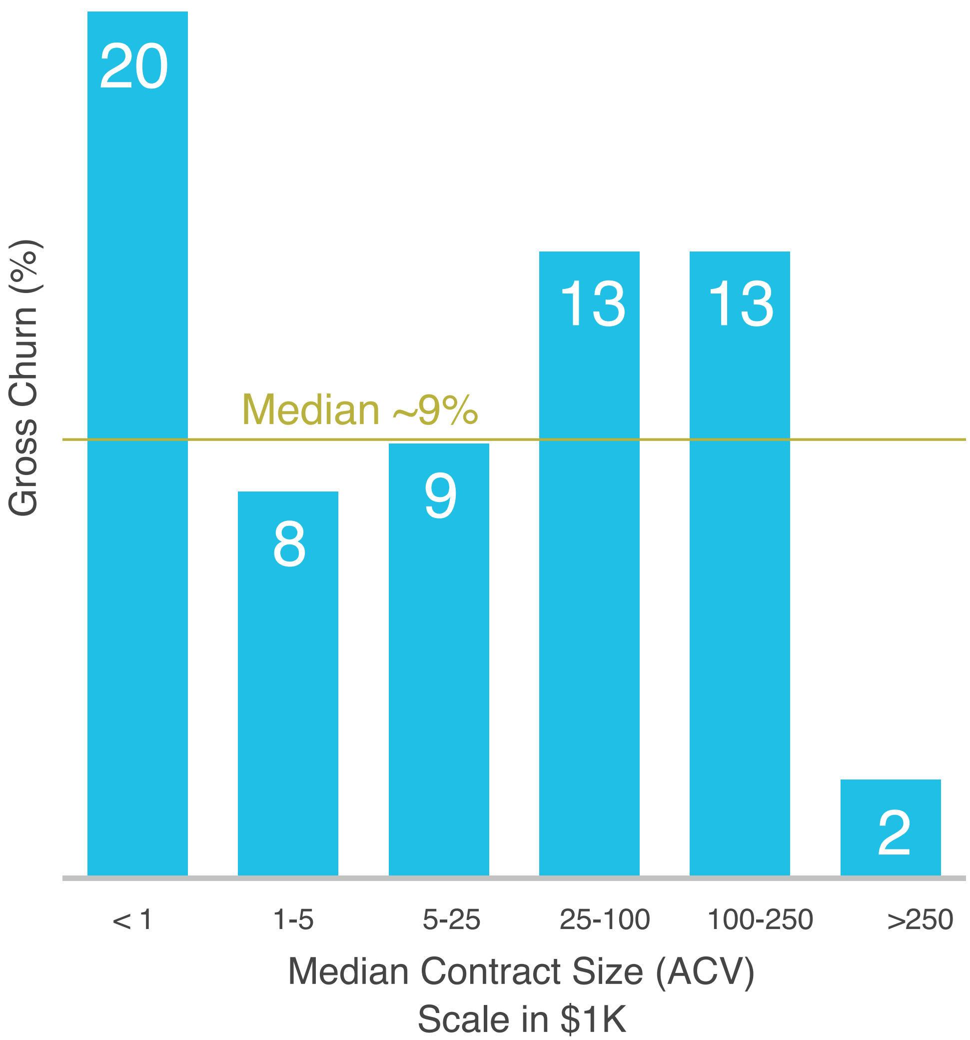
COMPARING CUSTOMER SUCCESS

Similarly, David Skok at Matrix Partners and Pacific Crest surveyed 66 firms and found a dollar churn rate distribution (not including up-sells) of:



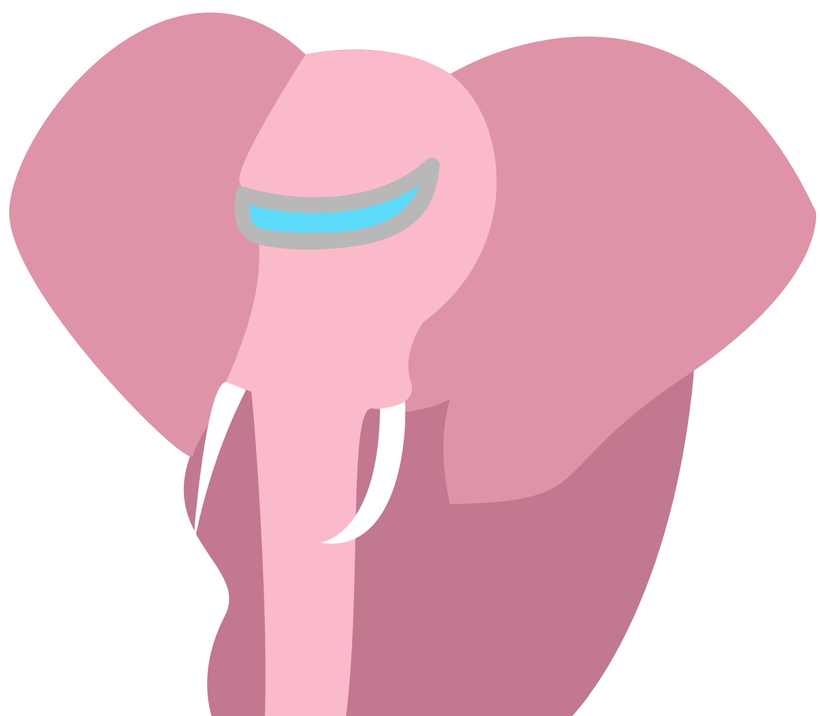
COMPARING CUSTOMER SUCCESS

The same survey found (not surprisingly) that high dollar customer contracts were more sticky:



It's important to understand that churn rates are not easily comparable across different industries. Some businesses are naturally sticky while others are very competitive. Businesses that sell to SMBs have a naturally high churn rate due to the high rate of churn of the customers' businesses themselves. And businesses with annual or longer-term contracts often hide churn rates for a long period of time, versus month-to-month businesses which constantly expose them.

FUTURE



FORECASTING CUSTOMER SUCCESS

ONCE you know where you are, you need to understand where you're going. Churn, like sales bookings, is fundamentally a "rear view mirror" metric. You can see what's happened in the past but you need to develop systems as an executive team to understand the future of the company's Customer Success.

And in many businesses, you have a mountain of data you could be reviewing to look into the "windshield" and see the future of Customer Success, much like leads and opportunities can predict future bookings. For example, customer health and probability to renew / up-sell and can be measured by looking at support tickets, invoice payments, survey feedback, customer engagement and product usage.

Validation of your forecast accuracy is important as well. If you're making assumptions about the impact of certain metrics or behavior on the end churn result, you should measure your forecasting effectiveness. The other executives will want to know that you aren't just reporting on churn but that you're truly understanding and forecasting it with reasonable predictability. You and your fellow executives are likely familiar with waterfall models and if you're reviewing your monthly churn numbers using a waterfall model, discussing the root cause behind any variance, and ideally reducing that variance over time, you're presenting and talking about churn in a consistent way with some of your other key metrics.

CUSTOMER HEALTH SCORECARD

ASK the management team to develop a customer health scorecard, capturing the elements they think are indicative of customer health and probability to renew / up-sell. Over time, the factors on this dashboard can be derived through data science, but near-term, intuition is a great place to start.

To start, determine the attributes of a healthy customer - these might include:

- Executive relationship: How is the relationship with your key sponsor at the account?
- Usage frequency: How often is your customer using your product or service?
- Key feature usage: Is your customer using your key / differentiated features?
- Training: Has your customer been trained and/or are they adept at your product?
- Support: Is your customer having a positive experience with your support organization?
- NPS: Is your customer providing positive feedback on your NetPromoter surveys?
- Billing: Is your customer paying invoices in a timely fashion?
- Reference: Is your customer acting as a reference, privately and publicly?

FORECASTING CUSTOMER SUCCESS

Many companies find interplay between these factors by looking at them holistically. For example, companies sometimes look at invoices outstanding from a collections lens, support tickets open from a call center lens and reference engagement from a marketing lens. But if a customer is slow paying bills, stopped calling support and won't be a reference anymore, alarm bells better be going off in your company.

For each attribute, determine your scoring system - e.g.,:

- Red/Yellow/Green
- 1-100
- 1-10
- etc.

In addition, determine how you will actually score each attribute. Some attributes are naturally qualitative (e.g., executive relationship), but you should strive as much as possible to determine quantitative, objective metrics for most measuring most elements of customer health.

CUSTOMER HEALTH SCORECARD

DETERMINE the weighted scoring model to calculate overall account health across all of the attributes.

You could track these attributes overall across your business, as well as by region and product. For example:

	Overall	Usage Frequency	Key Feature Usage	Support	Billing
Overall	80	90	70	50	60
US	90	95	80	60	70
EMEA	50	60	60	40	50
Product A	90	95	80	60	70
Product B	50	60	60	40	50

Then you should track these over time:

	Overall	Usage Frequency	Key Feature Usage	Support	Billing
January	80	90	70	50	60
February	90	95	80	60	70
March	50	60	60	40	50
April	90	95	80	60	70
May	50	60	60	40	50

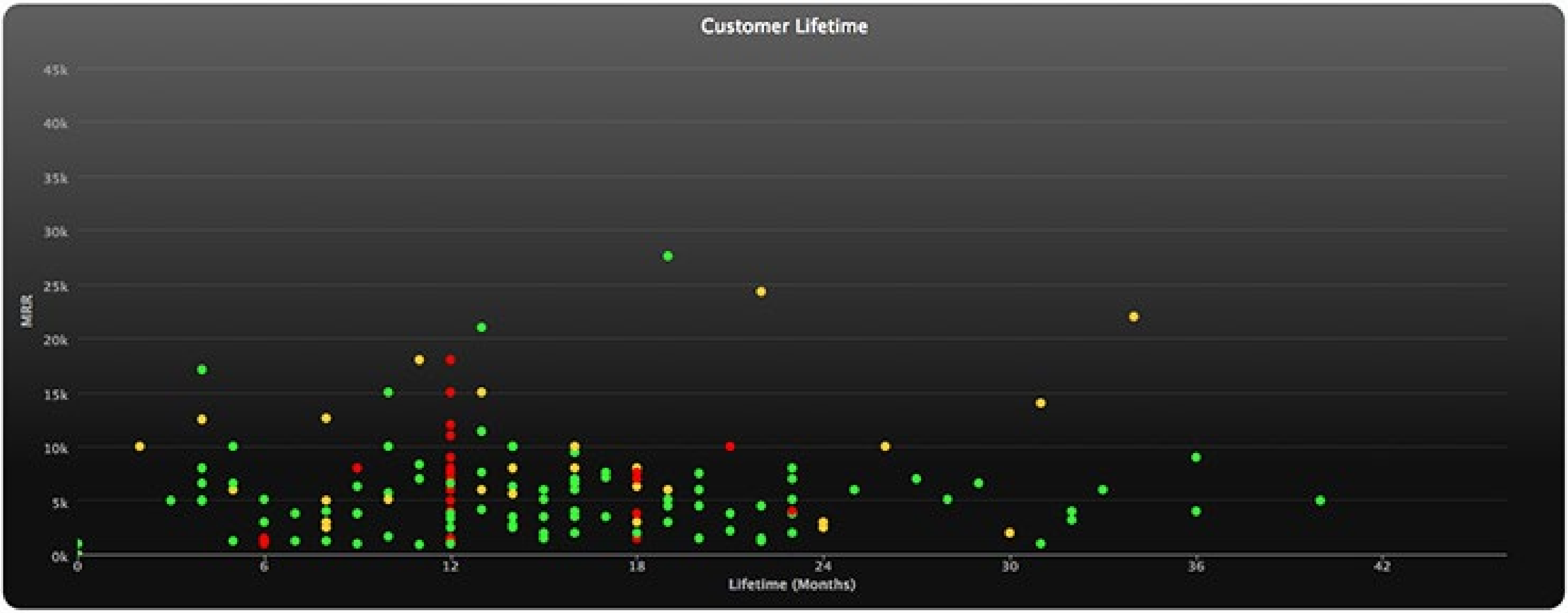
CUSTOMER HEALTH SCORECARD

And you should track health by customer for your top accounts:

	Overall	Usage Frequency	Key Feature Usage	Support	Billing
Customer A	80	90	70	50	60
Customer B	90	95	80	60	70
Customer C	50	60	60	40	50
Customer D	90	95	80	60	70
Customer E	50	60	60	40	50

CUSTOMER HEALTH SCORECARD

FINALLY, as Tom Tunguz from Redpoint Ventures discusses, you can look at your overall customer base by spend, tenure and health to determine how your "portfolio" of customers is doing. In this graph, the X-axis is the length of time a customer has been with you, the Y-axis is their spend (ARR/MRR) and the color coding of dots indicates the health of the customer.



EARLY WARNING SYSTEM AND PLAYBOOKS

NEXT, ensure the management team has an operational system in place to take the customer health score data above and identify at-risk customers and up-sell opportunities. Your management team should have consistent processes to intervene early enough to impact the outcome - far before the time of churn, renewal or up-sell.

Sometimes the intervention will involve the Customer Success team working with the customer and getting them to adopt parts of the product or service that will make your business more "sticky" over time. Other times, it will involve the Customer Success team playing the "quarterback" and leveraging resources from across the company in Professional Services, Support, Training, Product and Finance. Ensure that your team has a consistent and standardized approach to these engagements and a way to track they are happening.

For lower touch or broader-scale businesses, the intervention will involve powering a marketing automation system to send personalized emails to the customers at-risk or in opportunity to increase engagement. For example, if a customer is coming up for renewal and not using one of the modules they purchased, the campaign could include training videos, case studies and ROI points related to that specific module.

DATA SCIENCE

TYPICALLY, the above health scoring model and early warning system starts with your team's intuition, which is likely very strong. Your team understands what constitutes a "good" customers versus an "at risk" one. So intuition is a great place to start.

But to take it to the next level as you grow, ask the team to leverage statistical techniques from the world of data science to refine your customer health scoring model and early warning system. By running predictive analytics algorithms on your historical cohorts of customers that have stayed, churned and grown, you can find the correlating factors that predict a customer being in one bucket versus the other.

DATA SCIENCE

In our experience, you will likely end up:

- **Confirming some of your intuition and defining thresholds:** For example, you might have an intuition about customer login activity correlating to retention but you could find out the point at which to pull the alarm bell.
- **Disproving some of your intuition:** You likely will find some factors that your team believes are indicative of churn actually don't have a statistical correlation. For example, some companies find NetPromoter Score isn't correlated with churn but lack of response to surveys is. If you do find counterintuitive learnings, it doesn't mean you should ignore your intuition, but it definitely means you can't solely rely on it.
- **Generating new findings:** Most importantly, you will find new data points that you may have been ignoring (e.g., support ticket volume, usage of a specific feature, etc.) that could be indicative of churn or up-sell.

Then take these learnings and update your scoring and early warning models. And since your business is always changing with new industries, products, segments, etc., you'll want to regularly refine these models over time.

SUMMARY

SUMMARY

With respect to sales, the best executive teams have strong processes to understand where the company has been, where it is today and where it's going. Similarly, with the advent of the subscription economy, executives are going to need to develop comparable discipline around Customer Success.

Be ready to ask your management team:

- How do you measure Customer Success and churn / up-sell today?
- How do we compare versus peers in the industry?
- How healthy are our customers and how do we expect churn / up-sell to trend over time?

If nothing else, work with your fellow executive team to determine how you're going to measure, compare and forecast Customer Success for your business. For a sample Customer Success Executive Dashboard, click here.

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