THE UNIT ECONOMICS BIBLE

Every Metric Defined, Calculated, and Benchmarked

32 chapters across 8 parts

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PART I: FOUNDATIONS

Chapter 1: What Unit Economics Actually Are and Why They Predict Everything

Unit economics are the profit or loss generated on a per-customer basis. They answer the simplest and most important question in business: Do we make more money from this customer than we spend to acquire and serve them? This is not accounting. This is not GAAP. Unit economics are the ground truth of business viability. Every startup lives or dies based on unit economics, yet most founders obsess over vanity metrics like gross revenue, active users, or engagement while ignoring the metrics that actually determine survival.

The reason unit economics predict everything is because they measure the fundamental engine of business. Revenue without regard to cost is not a business plan—it's a charity that happens to charge money. A company with strong unit economics can grow sustainably, acquire capital at reasonable prices, and ultimately become valuable. A company with weak or negative unit economics will eventually exhaust its capital and collapse, no matter how popular the product is. This is not opinion. This is physics.

Unit economics are stage-dependent. What matters at a pre-seed stage looks entirely different at Series B. The metrics that investors obsess over change as your company scales. Many founders mistake this for permission to ignore unit economics early on. This is catastrophically wrong. Early-stage unit economics establish the trajectory that compounds throughout the lifetime of the company. If you have bad unit economics at $1M ARR, you will have worse unit economics at $10M ARR. The only exception is if you fundamentally change your business model, and few founders are willing to do that.

Understanding unit economics requires you to think about your business in layers. The first layer is the contribution margin—the gross profit per customer after direct costs. The second layer is the customer acquisition cost and how long it takes to recoup that investment. The third layer is the lifetime value—the total profit generated by a customer over their entire relationship with your company. The fourth layer is the efficiency of your marketing spend and sales organization relative to growth. When you understand these layers and how they

interact, you can see the entire financial structure of your company at a glance.

Unit economics are not pretty dashboards or executive presentations. They are calculated from real transaction data, real customer data, and real cost data. The more precisely you measure unit economics, the better decisions you make. Most founders avoid this because it's tedious and because the answer is often disappointing. This is a mistake. Disappointment early is preferable to catastrophe later.

Chapter 2: The Unit Economics Stack (Contribution Margin, Gross Margin, Operating Margin)

Unit economics is built in layers, and each layer serves a different purpose. The foundation is contribution margin—the money left over after you pay the direct costs of serving a customer. For a SaaS company, this includes cloud infrastructure, payment processing, customer support, and any other variable cost that scales with each additional customer. For an e-commerce company, this includes the cost of goods sold and fulfillment. Contribution margin is what you have available to cover customer acquisition costs and all fixed operating expenses.

Gross margin sits above contribution margin and includes more fixed costs that are directly attributable to serving customers. For a SaaS company, this might include dedicated customer success managers, implementation costs, or security infrastructure that scales with customer count but not strictly with each new customer. The distinction between contribution margin and gross margin matters because they tell you different things. Contribution margin tells you whether each individual customer adds value. Gross margin tells you whether your service delivery model is scalable at your current size.

Many SaaS companies confuse gross margin with contribution margin. They calculate gross margin as Revenue divided by (Revenue minus COGS), where COGS is everything that varies with customer count. This is contribution margin, not gross margin. True gross margin includes only the direct costs of the product—cloud infrastructure, payment processing, and perhaps customer support at a per-customer level. Everything else is operating expense. This distinction is important because it forces you to confront whether your business model works at scale.

Operating margin is the profit left over after you pay all costs, including customer acquisition, customer success, sales, marketing, product development, and general administration. Operating margin is the ultimate test of whether your business works. Companies with negative operating margins are not sustainable, regardless of how strong their unit economics are. A company with excellent contribution margin but bloated sales and marketing spending might have negative operating margins. This is why unit economics exist at multiple levels.

The typical progression is: Start with strong contribution margin (you make money on each customer after direct costs). Expand gross margin as you scale your delivery model (you deliver the product more efficiently). Keep operating expenses controlled so that your operating margin eventually becomes positive. Companies that skip steps in this progression—trying to achieve positive operating margins before they have strong contribution margins, for example—are building on sand.

Understanding the stack also means understanding the leverage points in your business. If contribution margin is weak, you need to reduce direct costs or increase revenue per customer. If gross margin is weak, you need to scale your delivery model. If operating margin is weak, you need to reduce fixed costs relative to revenue. Each layer has different solutions, and understanding which layer is your constraint is critical to improving unit economics.

Chapter 3: When to Start Measuring and When the Numbers Actually Matter by Stage

Most founders believe they have an excuse not to measure unit economics early on. When you have five customers, the argument goes, what good does it do to measure CAC or LTV? This thinking is backwards. Unit economics become more important, not less important, as you get smaller. With five customers, you can see exactly what the unit economics are. With five thousand customers, unit economics are buried in noise and require sophisticated analysis to extract.

You should start measuring unit economics as soon as you have revenue. Even if you have only $10k MRR, you should know your gross margin, your contribution margin, and your CAC. You should know which customers are profitable and which are not. You should know the cost structure of acquiring each customer. This information guides every subsequent decision about pricing, positioning, product roadmap, and hiring.

At the pre-product-market-fit stage (which typically means sub-$5k MRR for B2B SaaS), the unit economics you measure are provisional. You don't have enough data to make long-term claims. But you do have directional information about whether your business model is worth pursuing at all. If your contribution margin is negative, or if your gross margin is below 70%, or if you're spending $3 to acquire a $100 annual customer, these are signals that your business model needs rethinking. Early measurement prevents you from scaling a broken model.

At the product-market-fit stage ($5k to $30k MRR for SaaS), unit economics become critical inputs to your growth strategy. You now have enough data to make decisions about how aggressively to grow and which channels to invest in. You know whether your payback period allows for efficient growth. You know whether your lifetime value justifies your sales spending. Decisions about hiring, pricing, and positioning should all be driven by unit economics at this stage.

At the growth stage ($30k to $250k MRR), unit economics are the constraint on growth. Companies with excellent unit economics can raise capital easily and grow faster. Companies with mediocre unit economics struggle to fund growth and may need to reduce burn or change strategy. At this stage, investors scrutinize unit economics heavily, and they should. Unit economics either validate that the company is on a path to profitability and scale, or they signal that the business model has fundamental problems.

At the mature stage ($250k+ MRR), unit economics become less about the path to profitability and more about the efficiency of capital deployment. The company has likely already achieved positive unit economics (or the board would have intervened). The question is whether the company can grow efficiently enough to justify its valuation. This is when metrics like the Magic Number and burn multiple become central to investor discussions.

The numbers that matter change by stage. At early stage, focus on contribution margin, gross margin, and whether you can acquire customers at a reasonable cost. At growth stage, focus on payback period, LTV/CAC ratio, and NRR. At mature stage, focus on operating margin, cash conversion, and unit growth efficiency. Using the wrong metrics for your stage leads to wrong decisions.

PART II: CUSTOMER ACQUISITION COST

Chapter 4: CAC Calculated Correctly (The Formula Everyone Gets Wrong)

Customer Acquisition Cost (CAC) is the average fully-loaded cost of acquiring one customer. The formula is deceptively simple: Total Sales and Marketing spend divided by the number of new customers acquired. But the simplicity is deceptive. Almost every startup gets CAC wrong by excluding costs or misattributing them.

The correct formula includes all costs directly attributable to customer acquisition. This includes salaries and benefits for the sales and marketing team. It includes marketing spend on advertising, content, events, and tools. It includes sales commissions and bonuses. It includes sales and marketing software like Salesforce, HubSpot, and advertising platforms. It includes travel and entertainment. It includes customer onboarding costs specifically incurred to close the deal. Any cost that would not exist but for the goal of acquiring customers belongs in CAC.

What does not belong in CAC is product development, customer success, or general administration. These are operating expenses, not customer acquisition costs. A common mistake is including customer success and support in CAC. This is wrong. Support costs are variable with customer count but not causally related to the acquisition of new customers. They should be included in your cost of goods sold or gross margin calculation, not in CAC.

Another common mistake is to calculate CAC only from paid marketing spend. This is "Paid CAC" and it is useful, but it is not your true CAC. Your true CAC includes the fully loaded cost of your sales team, even if some of your customers come through inbound channels or are referred. If you have five salespeople and you acquire one hundred customers per year, your CAC includes the salaries and costs of those five salespeople divided by one hundred customers.

Many founders try to exclude certain costs from CAC to make the metric look better. They might exclude founder time (arguing that it's not a real cost) or exclude overhead (arguing that it's not directly attributable to sales and marketing). This is self-deception. If you're paying anyone a salary whose primary job is to acquire customers, that salary belongs in CAC. If you're spending money on a tool that is used solely for sales and marketing, that

cost belongs in CAC.

The correct approach is to calculate CAC at multiple levels. First, calculate your fully-loaded CAC, which includes all direct costs. Second, calculate your blended CAC across all channels (we'll cover this in the next chapter). Third, calculate your channel-specific CAC for each major acquisition channel. Fourth, calculate your cohort-specific CAC—the actual cost of acquiring the customers in a specific time period. The more granular you can be, the more actionable your unit economics become.

CAC should be calculated monthly and trended over time. Your CAC in month one of a marketing campaign might be very high (many costs upfront, few customers). Your CAC in month six might be much lower as brand awareness compounds and efficiency improves. Tracking CAC trends tells you whether your acquisition efforts are improving or deteriorating. A rising CAC trend is a warning sign that you need to revisit your strategy.

Chapter 5: Blended CAC vs Segmented CAC by Channel—Why Blended Is a Lie

Blended CAC is the average CAC across all of your customer acquisition channels. It is also almost always useless. The reason is that different channels have radically different CAC. Organic CAC might be $50. Paid search CAC might be $500. Direct sales CAC might be $5000. When you average these together into a blended CAC of $2000, you lose all the information that matters.

The blended CAC myth persists because it's simple and makes conversations with investors easy. You can say "Our CAC is $2000 and our LTV is $20000, so we have a 10x ratio, which is great." But this statement is false if your CAC is actually 50% organic at $50 and 50% sales at $5000. The organic channel should be grown rapidly. The sales channel should be reconsidered. Blending hides both truths.

Correct practice is to calculate CAC separately for each major acquisition channel. For a typical SaaS company, this means calculating CAC for: organic/inbound, paid search, paid social, partnerships, direct sales, and customer referrals. For each channel, you calculate the costs associated with that channel (salaries of people dedicated to that channel, tools used by that channel, media spend for that channel) divided by customers acquired through that channel.

Channel-specific CAC reveals the true economics of each acquisition engine. If your organic CAC is $100 and you're acquiring 10 customers per month through organic, that's a very different business dynamic than if you have a $5000 CAC and are acquiring 100 customers per month through direct sales. One business has a very efficient, scalable acquisition engine. The other has a high-touch, capital-intensive acquisition engine. These require completely different operating models.

Many companies discover through segmented CAC analysis that their "blended CAC" hides a crisis. They might discover that their paid marketing CAC is above their LTV, which means they're losing money on every customer acquired through paid channels. Meanwhile, their organic CAC is excellent. This should trigger an immediate reallocation of resources away from paid channels. But if you only track blended CAC, you would never see this.

The correct way to think about blended CAC is as a diagnostic metric for blending. If your blended CAC is rising over time even though your cost of capital acquisition is stable or improving, it tells you that you're shifting your customer acquisition mix toward higher-CAC channels. This might be intentional and correct, but it's worth understanding and discussing.

Investors want to see channel-specific CAC, not blended CAC. When a founder walks into a pitch meeting and says "Our CAC is $X," the first question an experienced investor will ask is "What's your organic CAC? What's your paid CAC? How much of your growth is coming from each?" If you don't have this data, you're signaling that you don't understand your own unit economics.

Chapter 6: Organic vs Paid Acquisition and How to Attribute Correctly

Organic acquisition is when a customer finds you without paid advertising. This includes inbound through organic search, word-of-mouth referrals, partnerships, press coverage, and pure luck. Organic customers feel free because you don't pay for advertising. But they are not free. There are costs associated with organic acquisition, and if you don't count them, you're lying to yourself about your unit economics.

The first cost of organic acquisition is the cost of creating the content, products, or partnerships that generate it. If you create a blog post that ranks for a high-intent keyword and that blog post generates customer inquiries, the cost of that blog post belongs in your organic CAC. If you build a free tier of your product that converts 2% of users to paid customers, the development and hosting cost of that free tier belongs in your organic CAC.

The second cost of organic acquisition is the cost of the team required to maintain, optimize, and manage your organic channels. If you have a content marketer who writes blog posts and optimizes SEO, their salary belongs in your organic CAC. If you have partnerships managers who cultivate channel partnerships, their salary belongs in organic CAC. The fully-loaded cost of these teams, divided by organic customers acquired, is your true organic CAC.

Many companies claim to have organic CAC below $100 when the real number is much higher. They attribute all inbound inquiries as "organic" and count only the cost of their content marketer as organic CAC. But they exclude the cost of the customer success team that onboards these inbound customers, the sales development team that qualifies them, and the product development effort that went into creating the free tier that drives the inbound. When you include all costs, organic CAC is often not much lower than paid CAC—it's just less obvious because the costs are spread across different departments.

Attribution is where most organic vs paid analysis goes wrong. A common scenario: A prospect sees your paid ad, doesn't convert, leaves. Later, they search for your product organically and convert. Most analytics platforms will attribute this to organic. But the reality is that the paid ad created awareness that made them search for you later. This is called "assisted conversion" and the cost should be shared between paid and organic channels.

The correct way to think about attribution is to model customer journey with multiple touchpoints. Did they come from paid, then organic, then referred? The contribution of each channel is a matter of debate—first-touch, last-touch, and multi-touch attribution models all have issues. For the purposes of unit economics, the best

approach is to use last-touch attribution (credit the channel the customer came from directly) but to acknowledge that this undercounts the contribution of awareness-building channels like content and brand marketing.

When you correctly account for all costs, organic acquisition is typically 2-4x more efficient than paid acquisition. This is not because organic is inherently cheaper, but because organic acquisition generates compounding returns over time. A blog post you write in month one generates leads in month twelve. A keyword you rank for generates leads for years. This compounding effect makes organic acquisition more efficient on a fully-amortized basis. But this only shows up if you track organic CAC correctly over time, measuring contributions of today's content two years hence.

Chapter 7: CAC by Business Model (SaaS, Marketplace, E-commerce, Services)

CAC varies dramatically by business model because the sales process and customer value vary. SaaS companies typically have longer sales cycles, higher contract values, and lower customer churn than e-commerce companies. This allows SaaS companies to spend more on customer acquisition because the lifetime value is higher. E-commerce companies have shorter sales cycles, lower contract values, and higher churn, which means CAC must be lower. Marketplaces and services have entirely different dynamics.

In SaaS, CAC typically includes the fully-loaded cost of sales and marketing teams. For an enterprise SaaS company selling to Fortune 500s, CAC might be $50,000 or more because the sales cycle is 6-12 months and requires multiple stakeholders. For a self-serve SaaS company, CAC might be $500 because customer acquisition is entirely through digital channels. Both are correct CAC calculations for those business models. The mistake is comparing them across business models without accounting for LTV differences.

In e-commerce, CAC is almost entirely paid acquisition. A customer might come from a paid search ad, a social media ad, or an affiliate link. The cost of acquiring that customer is the cost of the ad divided by the conversion rate. E-commerce CAC is typically very short-term—you calculate it based on the cost to acquire in a specific campaign, knowing that the customer might buy once or never again. This is fundamentally different from SaaS, where you calculate CAC assuming the customer will be with you for months or years.

In marketplaces, CAC must be calculated separately for supply and demand sides. Acquiring a seller in a marketplace might have a completely different CAC and LTV than acquiring a buyer. Uber's CAC for drivers is different from Uber's CAC for passengers. Airbnb's CAC for hosts is different from Airbnb's CAC for guests. Most marketplaces find that one side of the network has better unit economics than the other, which should guide investment priorities.

In services (consulting, agencies, professional services), CAC is typically dominated by the cost of the sales and business development team. There's usually no paid advertising. CAC is the fully-loaded cost of the team divided by the number of new clients acquired. For high-touch services, CAC can be very high (it might take three salespeople one year to land one client worth $500k per year). For transactional services (think legal document preparation), CAC might be purely digital and similar to e-commerce.

A critical mistake in SaaS is comparing CAC across price points without adjusting for LTV. A company selling $5,000/month contracts might have a CAC of $50,000 and think they're doing well. A company selling $500/month contracts might have a CAC of $3,000 and think they're doing poorly. But if the $500/month customer has a three-year lifetime and the $5,000/month customer has a two-year lifetime, the unit economics are similar. You must always calculate CAC in context of LTV.

The emerging best practice is to calculate "CAC efficiency" rather than absolute CAC. CAC efficiency is typically measured as CAC / ACV (where ACV is Annual Contract Value) or CAC / LTV. This ratio is more comparable across companies and business models. A CAC/ACV ratio of 1.0 or less is generally considered efficient. A CAC/LTV ratio of 0.3 or less is considered excellent. These ratios make cross-business-model comparisons more meaningful than raw CAC numbers.

Chapter 8: The CAC Trend That Investors Actually Care About

Investors do not care about your absolute CAC. They care about your CAC trend. A company with CAC of $5,000 that is rising to $6,000 is in trouble. A company with CAC of $10,000 that is falling to $8,000 is in strong position. Trends tell you whether your acquisition engine is getting more or less efficient as you scale.

For most companies, CAC rises in the short term as you add more marketing spend. You might double your advertising budget and acquire twice as many customers, but your CAC might rise by 30% because you're hitting less efficient channels or less responsive audiences. This is normal and expected. What matters is whether your CAC stabilizes and then declines as you optimize, or whether it continues to rise indefinitely.

The ideal CAC trend for an early-stage company is: CAC rises initially as you find product-market fit and begin to scale (months 1-6). CAC stabilizes as you optimize your acquisition playbook (months 6-18). CAC declines as you achieve scale economies and your brand awareness compounds (months 18+). If your CAC is still rising after 18 months of growth, you have a problem.

CAC trends should be tracked by cohort. The CAC of customers acquired in January should be compared to the CAC of customers acquired in February, controlling for the costs incurred that month. This is more accurate than tracking "overall" CAC trend because it avoids seasonality and accounting for changes in spending. A cohort-based CAC trend is the most honest measure of whether your acquisition is getting more or less efficient.

There are two patterns of CAC trends that investors worry about. First, a rising CAC trend despite stable or declining marketing spend. This suggests that the easy-to-acquire customers have been exhausted and you're left with harder, more expensive customers. This is a sign that you need to shift to a new market, new product, or new acquisition channel. Second, a rising CAC trend due to rapidly increased marketing spend but flat or declining customer acquisition. This suggests that your acquisition playbook is breaking down as you scale.

The flip side of a good CAC trend is what investors call "unit economics improving." This happens when you combine a declining CAC trend with stable or growing LTV. You're acquiring customers more efficiently while they become more valuable. This is the business traction that converts skeptical investors into enthusiastic backers. The question is not "What is your CAC?" but "Is your CAC trending in the right direction?"

A note of warning: Some companies artificially improve their CAC trend by changing their customer mix. They might shift toward smaller contracts that are cheaper to acquire, lowering CAC but also lowering LTV. Or they might shift toward lower-churn customers by being more selective in acquisition, which lowers CAC but also lowers growth. When you see a CAC trend improving, always ask "Is this because acquisition is truly getting more efficient, or because the customer mix is changing?" The answer determines whether the trend is healthy or misleading.

PART III: LIFETIME VALUE

Chapter 9: LTV from First Principles (Not Just ARPU / Churn)

Lifetime Value (LTV) is the total profit generated by a customer over their entire relationship with your company. The most common formula is ARPU (Average Revenue Per User) divided by churn rate, which gives you revenue-based LTV. But this formula is misleading because it ignores costs. A customer might generate $10,000 in revenue but cost $12,000 to serve, resulting in a negative LTV. Revenue-based LTV is not LTV; it's just ARPU.

True LTV starts with contribution margin, not revenue. Contribution margin is the revenue from a customer minus the direct costs of serving that customer (cloud infrastructure, payment processing, customer support, etc.). LTV is contribution margin summed over the entire customer lifetime. This is the profit you actually make on a customer.

The formula for LTV from first principles is: (Average Monthly Contribution Margin) multiplied by (Average Customer Lifetime in Months). This is deceptively simple. The challenge is calculating both components correctly. Average monthly contribution margin requires you to know your gross margin (revenue minus direct costs of goods sold) and then divide by the number of customers. If you have $100,000 in gross profit and 100 customers, your average monthly contribution margin is $1,000 per customer.

Average customer lifetime is typically calculated from churn. If your monthly churn rate is 5%, then on average, a customer lasts 20 months (one divided by 0.05). If your monthly churn rate is 2%, then your average customer lasts 50 months. This is an oversimplification (early churn is typically higher than steady-state churn) but it's a reasonable starting point.

Many companies make the mistake of calculating LTV including marketing and sales costs. They reason that you incur CAC to acquire the customer, so shouldn't that reduce LTV? The answer is no. LTV should be calculated separately from CAC. LTV is the profit you make from a customer. CAC is the cost to acquire the customer. The LTV/CAC ratio is the relationship between the two, but they should not be mixed. If you net out CAC from LTV,

you lose the ability to see whether your acquisition economics work at all.

A more sophisticated LTV calculation uses cohort analysis. You take a cohort of customers acquired in a specific month, track their contribution margin month by month, and sum the total contribution margin until they churn. This is cohort-based LTV, and it's much more accurate than the formula-based approach because it captures the actual pattern of customer lifetime value in your business.

LTV also varies by segment. High-enterprise customers might have an LTV of $100,000 while mid-market customers have an LTV of $20,000. Customers acquired through organic channels might have an LTV of $30,000 while customers acquired through paid channels have an LTV of $15,000. When you calculate company-wide LTV without segmenting, you're averaging together very different customer types, which obscures the real unit economics of each segment.

Chapter 10: Cohort-Based LTV—The Only Method That Doesn't Lie

Cohort-based LTV is the gold standard for calculating true lifetime value. Instead of relying on assumptions about average churn and average revenue, you take a cohort of customers acquired in a specific month, track their contribution margin month by month, and sum the total. This captures the actual behavior of real customers, not theoretical averages.

The process is straightforward. Take all customers acquired in January 2024. Calculate the total contribution margin generated by this cohort in January, February, March, and every month thereafter until most of the cohort has churned. Sum this total. Divide by the number of customers in the cohort. This is the LTV of the January 2024 cohort.

Cohort-based LTV reveals patterns that formula-based LTV misses. You might discover that customers acquired in January 2024 have much higher LTV than customers acquired in April 2024, even though both cohorts have the same churn rate. This might indicate that you changed pricing, changed product, changed your customer success process, or changed the type of customer you were acquiring. Understanding these variations is essential for improving unit economics.

Cohort-based LTV also reveals the "cliff" pattern. Many companies acquire customers who stay for exactly one year and then churn at high rates. Others have customers who stay for three months then churn. Understanding when the cliff happens is crucial because it tells you whether your retention is stable or whether customers are leaving at a specific decision point (renewal time, contract anniversary, etc.).

A limitation of cohort-based LTV is that you must wait for the cohort to fully mature before you know the true LTV. If you're calculating cohort LTV for customers acquired in January, you probably can't calculate full LTV until January of the following year at earliest. For high-churn products, the cohort stabilizes quickly. For low-churn products, you might need to wait two or three years to see the full picture.

The workaround is to calculate partial LTV and then extrapolate. If you see that a cohort has stabilized (churned down to a small percentage remaining), you can project the remaining lifetime value based on the retention curve. This requires assumptions, but it's more accurate than assuming steady-state behavior without evidence.

Cohort-based LTV is essential for identifying which cohorts have good unit economics and which have bad unit economics. If January 2024 cohorts have $30k LTV but April 2024 cohorts have $15k LTV, something changed. You need to investigate what happened between these two cohorts. Did you change pricing? Did product quality degrade? Did you start acquiring lower-quality customers? Did you hire poor customer success managers? Cohort-based LTV is your diagnostic tool for identifying when unit economics break.

Chapter 11: LTV With and Without Gross Margin—Which to Use When

There are two ways to calculate LTV: gross margin-based LTV and contribution margin-based LTV. Gross margin LTV includes the cost of customer success, support, and other scalable costs of serving the customer. Contribution margin LTV includes only the direct variable costs (COGS, payment processing, infrastructure). The choice of which to use determines everything about how you interpret your unit economics.

Contribution margin LTV is the profit you have available to cover customer acquisition costs and fixed operating expenses. This is the "cash available" LTV. If your contribution margin LTV is $20,000 and your CAC is $3,000, you have $17,000 available to cover your fixed costs (salaries, rent, etc.). This is the most important LTV for understanding whether your business model works at all.

Gross margin LTV is the profit left over after you pay for all scalable delivery costs (customer success, support, implementation). This is the "what's left for the company" LTV. If your gross margin LTV is $8,000, then you have $8,000 per customer to cover all operating expenses (sales and marketing, product development, general administration). This determines whether your company can be profitable at scale.

The relationship between the two is: Contribution Margin LTV = Gross Margin LTV + (Customer Success / Support costs per customer lifetime). If you outsource all customer success to a partner, your contribution margin LTV might be equal to your gross margin LTV. If you build a large customer success team, the gap widens.

Most SaaS companies should calculate both. Contribution margin LTV tells you whether you should be spending money on paid acquisition. Gross margin LTV tells you whether you can afford to build a customer success organization. If your contribution margin LTV is $20,000 but your gross margin LTV is $5,000, it means you're spending $15,000 per customer on customer success. This might be necessary for your market, but it limits your operating leverage.

Many investors want to see both metrics separately. CAC payback is typically calculated using contribution margin (how long until the gross profit from the customer covers the CAC). LTV/CAC ratio is typically calculated using gross margin (the total profit after all customer-facing costs). The choice of metric affects the story you tell about your unit economics.

A critical insight: Gross margin LTV divided by CAC tells you the maximum sustainable operating margin. If your gross margin LTV is $8,000, your CAC is $2,000, and you have no other operating costs, your company could theoretically achieve a 75% operating margin. But you have operating costs, so the realistic operating margin is much lower. Understanding this relationship helps you calibrate the maximum possible operating margin for your business model.

Chapter 12: LTV by Segment, Channel, and Geography

LTV varies significantly by customer segment, and companies that ignore this variation are flying blind. Enterprise customers might have an LTV of $100,000 while mid-market customers have an LTV of $20,000 and SMB customers have an LTV of $3,000. These differences are driven by differences in contract value, churn rate, and expansion revenue. If you calculate a blended LTV across all segments, you're averaging together very different customer types.

The reason LTV varies by segment is usually multifaceted. Enterprise customers have longer implementations, which means they churn less in year one. They're more likely to expand and buy multiple products over time. They have higher switching costs because they're more integrated into your product. Mid-market and SMB customers are more price-sensitive, more likely to churn after one year, and less likely to expand. These are fundamental business model differences, not execution differences.

LTV also varies by acquisition channel. Organic customers often have higher LTV than paid customers because they come with higher intent and lower expectations (they weren't promised anything in an ad). Referred customers often have even higher LTV because they have implicit endorsement from their peer. Directly-sold customers might have medium LTV because you can navigate them through implementation but they might churn if you lose the relationship. Understanding channel-specific LTV is essential for optimizing your acquisition strategy.

Geography is a critical variable that many companies ignore. Customers in the United States might have an LTV of $30,000 while customers in India have an LTV of $3,000, simply because of differences in pricing power and churn rates. International expansion often looks worse on unit economics than domestic business, which should inform your geographic strategy.

The correct approach is to calculate LTV for every meaningful segment: by company size, by industry, by geography, by acquisition channel, and by customer cohort. You should be able to answer the question "What is the LTV of a mid-market SaaS company in the US acquired through organic channels?" If you can't answer that with real data, you don't understand your business.

Segmented LTV reveals where your business is actually working. You might discover that enterprise customers are profitable while SMB customers are not. This should trigger a pivot in your go-to-market strategy—perhaps hiring more enterprise salespeople and deprioritizing self-serve. You might discover that customers in certain verticals have much higher LTV than others. This should guide your product roadmap and marketing focus.

One more critical insight: LTV by segment helps identify cross-subsidies in your business. You might discover that your high-churn segment is subsidizing your low-churn segment in your pricing. Or that customers acquired through one channel subsidize customers acquired through another. These hidden subsidies are often unintentional and should be corrected through repricing or repositioning.

Chapter 13: The LTV/CAC Ratio and Why 3x Is Not Always the Answer

The LTV/CAC ratio is the most-cited metric in SaaS for evaluating unit economics. The conventional wisdom is that a 3x LTV/CAC ratio is good, meaning you make $3 in lifetime profit for every $1 you spend acquiring a customer. But this rule of thumb is misleading and often leads to wrong decisions.

The LTV/CAC ratio is useful as a screening metric, but it obscures the factors that actually matter. A company with 3x LTV/CAC could have a short payback period (excellent) or a long payback period (mediocre). A company with 2x LTV/CAC could be more efficient than a company with 4x LTV/CAC if the 2x company has faster payback and lower churn. The ratio alone doesn't tell you enough.

The reason 3x is considered the threshold is that it leaves room for operating costs. If LTV/CAC is 3x, you have $2 of gross margin per $1 of CAC. After paying all your operating expenses (product development, general administration, etc.), you have some left over for profit. But the appropriate LTV/CAC ratio depends entirely on your cost structure. A company with high gross margins can sustain a lower LTV/CAC ratio. A company with low gross margins needs a higher ratio.

A more useful way to think about LTV/CAC is through the lens of payback period. If your CAC is $5,000 and your monthly contribution margin is $500, your payback period is 10 months. If your CAC is $5,000 and your monthly contribution margin is $1,000, your payback period is 5 months. Payback period is more actionable than LTV/CAC because it tells you how quickly you recoup the acquisition cost—which determines how aggressively you can grow before running out of capital.

Another issue with LTV/CAC is that it assumes you know your true LTV, which you often don't. If you haven't been in business long enough to see full customer lifetimes, you're extrapolating from incomplete data. A company might claim 4x LTV/CAC based on projections, but the true LTV might be 2x once customers reach natural maturity.

The right mental model is: LTV/CAC should be high enough that you have room for operating margins. In practice, this means: LTV/CAC of 2-3x for venture-backed companies in growth mode (because you can burn cash and return to profitability later). LTV/CAC of 3-4x for companies targeting profitability in the near term. LTV/CAC of 5x+ for companies targeting very high operating margins or very capital-efficient growth.

Where LTV/CAC becomes truly useful is in longitudinal tracking. If your LTV/CAC was 3x last year and is now 4x, you're improving unit economics (either LTV is growing or CAC is shrinking). If it was 4x and is now 2x, you have a serious problem. Trends matter more than absolute numbers.

The biggest mistake with LTV/CAC is using it to justify bad decisions. Some companies chase high LTV/CAC ratios by raising prices, narrowing their target market, or requiring longer commitments. This might improve the ratio but it often reduces growth and total value creation. The LTV/CAC ratio is a means to sustainable growth, not an end in itself.

PART IV: RETENTION METRICS

Chapter 14: Logo Churn vs Revenue Churn—The Critical Distinction

Logo churn is the percentage of customers (by count) that cancel each period. Revenue churn is the percentage of revenue (in dollars) that is lost each period. These two metrics can diverge significantly, and the divergence tells you something critical about your unit economics.

A typical pattern: You have 100 customers. 5% of them churn (5 customers), so your logo churn is 5%. But the 5 customers that churned might have been your smallest accounts, each paying $1,000/month. The remaining 95 customers are larger, averaging $5,000/month. Your total revenue drop is $5,000, which is 1% of $500,000, so your revenue churn is 1%. This company has high logo churn but low revenue churn.

The opposite pattern exists too. A company might have 100 customers, only 1% churn by count, but that 1 customer was a $50,000/month enterprise customer. Your logo churn is 1% but your revenue churn is 5%. This company has low logo churn but concerning revenue churn because it depends on large customers.

Which metric matters more? Revenue churn is what determines your company's financial health. A company with high logo churn but low revenue churn can have healthy unit economics because the revenue base is stable. A company with low logo churn but high revenue churn is in serious trouble because it depends on customers who are likely to leave.

However, logo churn is also important because it tells you about product-market fit and customer satisfaction. High logo churn indicates that many customers don't find value and leave. Even if those customers are small and don't affect revenue much, high logo churn is a signal that something is wrong with product or positioning.

The ideal pattern is low logo churn and low revenue churn. This indicates that you have product-market fit, customers find value and stay, and you don't have lumpy revenue from large customers. The second-best pattern is low revenue churn with moderate logo churn. This indicates that you have a stable revenue base even if you're

churning some small customers.

Many companies hide poor logo churn behind strong net revenue retention (which we'll cover in the next chapter). They might have high logo churn offset by strong expansion revenue from remaining customers. This can work for a while, but it's not stable because the revenue from existing customers eventually plateaus and then contracts.

The most important insight: If logo churn and revenue churn diverge significantly, your business model has embedded inequality. You're losing many small customers but retaining few large customers. This makes your business less resilient and more dependent on relationship management with large accounts. Over time, this becomes a vulnerability.

Chapter 15: Net Revenue Retention (NRR)—The Metric That Predicts Everything

Net Revenue Retention (NRR) is the percentage of revenue from existing customers that is retained from one period to the next, including expansion revenue but accounting for churn. The formula is: (Starting Revenue + Expansion Revenue - Churn) / Starting Revenue. For a SaaS company, if you start the year with $1 million in ARR and end with $1.2 million (because you lost $200k to churn but gained $400k from upgrades), your NRR is 120%.

NRR above 100% means you're growing revenue from your existing customer base without acquiring any new customers. This is the holy grail of SaaS unit economics. It means your product is becoming more valuable to customers over time, they're expanding their usage, and the value they get is increasing. NRR above 120% is considered exceptional. Above 130% is rare and indicates a company with very strong unit economics.

Why does NRR predict everything? Because NRR is a leading indicator of whether your business can grow sustainably. A company with NRR of 120% can grow just by keeping customers (no need to acquire anyone). A company with NRR of 100% needs to acquire customers to grow. A company with NRR below 100% is contracting even if it's acquiring new customers at a rate that matches or exceeds churn (this is because churn is larger than growth).

Investors obsess over NRR because it's a pure signal of product quality and customer success. You can fake many metrics—you can manipulate CAC by changing your accounting, you can inflate LTV by assuming low churn. But NRR is hard to fake. It's calculated from real customer data: how much revenue were you making from customer X last year, and how much are you making now? The answer is in your financial records and can't be argued with.

NRR above 110% is the threshold where many SaaS companies transition from "growth dependent on acquisition" to "growth partially dependent on expansion." This is significant because it changes the unit economics of the entire business. If you have NRR of 110%, you can invest heavily in CAC and still hit growth targets because your existing revenue base is growing 10% annually just from expansion.

However, NRR has limitations. A company with NRR of 100% and 0% churn is very different from a company with NRR of 100% and 50% churn offset by 50% expansion. The first is stable. The second is dependent on continued expansion revenue to offset churn. The second company is more vulnerable if expansion slows.

To understand NRR fully, you must also look at its components. What percentage of NRR comes from expansion (upsell, cross-sell) and what percentage comes from unchanged existing customers? A company with high expansion but high churn is different from a company with low expansion but low churn. Both might have the same NRR but very different trajectories.

The benchmark for NRR varies by stage. Early-stage companies (below $5M ARR) often have NRR below 100% because they don't have mature expansion plays yet. Growth-stage companies ($5M to $50M ARR) typically have NRR of 100-120%. Mature companies ($50M+ ARR) often have NRR of 110-130%. If your NRR is below your stage's benchmark, it's a red flag.

Chapter 16: Gross Revenue Retention and What It Tells You That NRR Hides

Gross Revenue Retention (GRR) is the percentage of revenue from existing customers that you retain before accounting for expansion revenue. The formula is: (Starting Revenue - Churn) / Starting Revenue. If you start with $1 million in ARR and lose $200k to churn, your GRR is 80%.

The difference between GRR and NRR reveals the power of expansion. If your GRR is 80% (losing 20% to churn) but your NRR is 110% (gaining 10% from expansion), it means you're expanding customers enough to more than offset churn. This is good news, but it also masks a warning signal. You're only gaining 10% of revenue growth from the growth that matters—expansion from happy customers.

GRR is more honest than NRR about the health of your retention. A company with GRR of 80% and NRR of 110% is in the danger zone. The company is churning customers at a high rate, and only able to offset it through aggressive expansion to remaining customers. What happens when expansion slows? The company suddenly looks less healthy.

A company with GRR of 95% and NRR of 110% is in much better shape. The company is retaining most customers and expanding within those retained customers. This is a combination of good retention and good expansion—the ideal outcome.

GRR below 90% is a warning sign that your retention is weak. Even strong expansion revenue can't offset the loss of customers. Companies with GRR below 90% often find that their growth decelerate as they exhaust their expansion opportunities with remaining customers and churn accelerates.

The most important insight from GRR is that it reveals hidden dependencies. Many companies with strong NRR metrics have weaker GRR metrics underneath. The expansion revenue is masking the fact that the company is losing customers. This works until expansion revenue plateaus or slows, at which point the company's growth profile suddenly deteriorates.

The ideal pattern is: High GRR (95%+) with strong expansion revenue (NRR of 110-130%). This indicates the company is both retaining customers well and expanding within those customers. The second-best pattern is: Moderate GRR (85-90%) with very strong expansion revenue. The worst pattern is: Low GRR (80%+) with moderate expansion revenue. This company is in decline.

GRR also varies by segment, which is important to understand. Enterprise customers might have GRR of 95% while SMB customers have GRR of 75%. This divergence tells you that your product is becoming more sticky for large customers but less sticky for small customers. This should inform your go-to-market strategy and product roadmap.

Chapter 17: Cohort Retention Curves and How to Read Them

A cohort retention curve shows what percentage of a cohort of customers (acquired in a specific month) are still customers in each subsequent month. If you acquire 100 customers in January, a retention curve might show 95 remaining in February, 90 in March, 85 in April, and so on. This visualization reveals the true pattern of customer retention in your business.

The shape of the retention curve tells you about the health of your retention. An ideal curve has a steep drop in the first month (customers who never really engaged churn quickly) and then a much gentler slope thereafter. This pattern indicates that customers self-select for actual value—engaged customers stay, disengaged customers leave quickly. A curve with consistent decline over many months suggests that customer churn is spread out—there's no sharp cliff where customers decide the product isn't for them.

A retention curve with a sudden cliff—flat for many months and then a sharp drop—often indicates a contract renewal event. Customers stay for their first contract year and then many churn at renewal. This is a critical insight because it tells you that your retention problem isn't about ongoing dissatisfaction—it's about a failure to demonstrate enough value by contract renewal time.

The steepness of the retention curve tells you something about product-market fit. A very steep curve (50% of cohort churns in month one) indicates weak product-market fit—many customers don't find value immediately. A gentle curve (90%+ of cohort stays through month 12) indicates strong product-market fit—customers engage and stay engaged.

Comparing cohort retention curves across time reveals whether your retention is improving or degrading. If January 2024 cohort has 85% retention at month 6 but January 2025 cohort has 80% retention at month 6, your retention is degrading. This might indicate that you changed the product, lowered quality, started acquiring lower-quality customers, or that the market became more competitive.

Cohort retention curves also reveal the impact of product launches or changes. If you released a major feature in March, you should see a noticeable change in retention curves for cohorts acquired before and after the launch. Better retention after the launch indicates the feature improved retention. Worse retention indicates the feature created problems or distracted from core value.

A critical pattern to watch for is cohort quality degradation. If January 2024 cohorts have 85% one-year retention but January 2025 cohorts have only 70% one-year retention, you've degraded your customer acquisition. You

might be acquiring less-qualified leads or customers who don't fit your ideal customer profile. This is a leading indicator that unit economics will deteriorate in the future.

The inverse can also happen: improving cohorts. If your retention curves are consistently better for more recent cohorts, it indicates that you're improving the product, improving customer success, or acquiring better-fit customers. This is a sign of a company getting healthier.

Chapter 18: Retention by Segment and the Hidden Subsidies in Your Business

Retention varies significantly by customer segment, and companies that ignore this variation are often subsidizing bad business units with good ones. Enterprise customers often have 95%+ retention while SMB customers have 70% retention. Customers acquired through enterprise sales often have better retention than customers acquired through self-serve. Geography also affects retention—US customers might have 85% retention while APAC customers have 65%.

When you calculate company-wide retention without segmenting, you're averaging together very different customer types. A company might report 80% overall retention and think it's healthy, when in reality enterprise customers have 95% retention and SMB customers have 65% retention. The company is subsidizing SMB growth with enterprise profits.

The reason retention varies by segment is usually deep business model differences. Enterprise customers are more integrated with your product—it's embedded in their workflows and teams. They have higher switching costs because they've invested in implementation and training. They have champion users who advocate for the product. SMB customers have lower switching costs and often are one-person operations where the champion might leave.

Discovering hidden subsidies through segmented retention analysis should trigger strategic decisions. If SMB retention is terrible, you have options: invest heavily in customer success to improve retention, raise prices to fund better service, pivot to higher-touch enterprise sales, or deprioritize SMB entirely. But you can't make these decisions without understanding the problem first.

A common finding is that self-serve customers have lower retention than sales-assisted customers. This often leads companies to shift toward sales-assisted models. But be careful with this conclusion—lower retention might not be the model's fault. It might be that self-serve attracts a different customer type (ones with lower-intent, lower-fit) who would churn even if they came through sales.

Retention by geography reveals market maturity and localization needs. Customers in your home country might have better retention because the product is optimized for that market's language, cultural norms, and business practices. International customers might have lower retention because the product requires localization work. This should inform your international expansion strategy.

The most important insight about retention subsidies: They're often unintentional but they're always real. Your pricing might not reflect the true cost-to-serve different segments. Enterprise customers might be profitable at

95% retention while SMB customers are unprofitable at 65% retention. Your blended margins hide this. Once you understand segmented retention, you can reprrice accordingly.

PART V: GROSS MARGIN

Chapter 19: COGS in SaaS vs Marketplace vs E-commerce vs Services

Cost of Goods Sold (COGS) is the direct cost of delivering your product or service to a customer. The definition varies by business model, which is why so many companies misclassify their COGS. Getting this right is critical because COGS determines gross margin, which determines whether you have enough profit to cover sales, marketing, and R&D costs.

In SaaS, COGS typically includes: cloud infrastructure (servers, storage, data transmission), payment processing fees (Stripe takes 2.9% + $0.30 per transaction), customer support (sometimes), and any third-party services integrated into your product. SaaS COGS is often surprisingly low—15-30% of revenue is common for well-optimized SaaS. This is why SaaS has such attractive gross margins.

A critical decision in SaaS is whether to include customer success in COGS. If customer success is essential to product value delivery (e.g., you're a professional services platform that requires onboarding), include it in COGS. If customer success is more about reducing churn and expanding accounts (which is also important but not directly tied to delivering the product), exclude it from COGS and count it as a sales and marketing expense or operating expense. The choice reveals how you think about your business model.

In marketplaces, COGS is typically the take rate—the revenue that flows to the platform operator minus the revenue that flows to the supply side. If Uber takes 30% of each ride, the COGS is 70% (the driver's cut). For Airbnb, if Airbnb takes 14% from the guest and 3% from the host, the COGS is effectively the money that goes to the supply side. Marketplace COGS is often 50-80% of revenue depending on the market dynamics.

In e-commerce, COGS is the cost of goods plus fulfillment. If you sell a shirt for $50 and the shirt costs $15 to manufacture and $5 to fulfill, your COGS is $20, and your gross margin is 60%. E-commerce COGS can be high (40-70%) because you're buying inventory and paying for fulfillment. This limits gross margin and operating leverage.

In services (consulting, agencies, services), COGS is typically labor cost. If you're a consulting firm that sells $200/hour consulting and your average burdened labor cost is $100/hour, your COGS is 50% and your gross margin is 50%. Services have highly variable COGS depending on labor utilization and labor cost. High-utilization businesses have better COGS. High-labor-cost businesses have worse COGS.

A critical mistake is including fixed costs in COGS. COGS should only include variable costs—costs that scale with the number of customers or volume of sales. Your office lease is not COGS. Your engineering team salary is not COGS (it's R&D). Your CFO's salary is not COGS. Only count the costs that go away if you sell one fewer unit.

Another mistake is timing. COGS should be matched to revenue. If you pay for cloud infrastructure upfront but revenue is spread over a month, match the expense to the revenue period, not the payment period. This requires accrual accounting, which many early-stage companies skip.

The benchmark for COGS varies by business model. SaaS: 15-35%. Marketplace: 50-80% (depends on payment structure and take rate). E-commerce: 40-70%. Services: 40-60%. If your COGS is outside these ranges, investigate why. You might be more efficient than competitors (good) or you might be miscalculating (bad).

Chapter 20: Gross Margin Benchmarks by Business Model and Stage

Gross margin is the percentage of revenue left after paying COGS. The formula is: (Revenue - COGS) / Revenue. Benchmarks vary significantly by business model, and using the wrong benchmark will lead to wrong conclusions about your unit economics.

For SaaS, gross margins should be 60-80% at scale. Early-stage SaaS companies often have lower gross margins (40-60%) because they haven't optimized infrastructure and they might be doing customer success work that they'll eventually automate or systematize. As SaaS companies scale, gross margins should improve because infrastructure costs are amortized across more customers. If your SaaS gross margin isn't improving as you scale, you have a problem—either your cost structure isn't scaling or you're adding features that increase COGS.

For marketplaces, gross margins should be 40-60% (accounting for the take rate paid to supply). This is lower than SaaS because marketplaces have higher variable costs. The goal is to improve take rate as the platform becomes more efficient or as more supply enters the platform.

For e-commerce, gross margins should be 30-50% depending on the category. Luxury goods have higher margins. Commodities have lower margins. Amazon's gross margin is around 45%, which is typical for large-scale e-commerce. If your e-commerce gross margin is below 30%, your business model might not work.

For services, gross margins should be 50-70% depending on service type and delivery model. High-touch consulting has lower gross margins because of labor cost. Productized services or training have higher gross margins because they can be delivered more efficiently. If your service gross margins are below 40%, you're not charging enough or your delivery model is too expensive.

Gross margin evolution by stage is important. At $1M ARR, your gross margin is often not at peak. At $10M ARR, it should be improving. At $50M ARR, it should be near peak. If gross margin deteriorates as you scale, investigate why. You might be adding high-COGS services, expanding into lower-margin geographies, or losing pricing power.

A common pattern in SaaS is gross margin improvement as you scale. At $1M ARR, a SaaS company might have 60% gross margin. By $10M, it's 70%. By $50M, it's 75%. This improvement comes from better infrastructure optimization, higher sales volume of larger features that have lower COGS, and greater bargaining power with cloud providers.

However, some SaaS companies see gross margin decline as they scale because they invest heavily in customer success or because they add lower-margin customer tiers. This is a choice, not a requirement. Understand your trajectory and whether it's intentional.

The relationship between gross margin and operating leverage is critical. If gross margin is 60%, you have 40% of revenue available to pay for sales, marketing, R&D, and general administration. If you spend 30% on sales and marketing, you have 10% left for R&D and overhead. This determines the maximum operating margin you can achieve. A company with 50% gross margin will struggle to achieve 20% operating margins even if sales and marketing are efficient.

Chapter 21: The Gross Margin Expansion Path and What Drives It

Gross margin expansion is one of the most important unit economics trends to track. A company that improves gross margin from 65% to 75% over several years has dramatically improved unit economics. Every percentage point of gross margin improvement flows through to operating margin if operating expenses stay constant.

What drives gross margin expansion? The main drivers are: infrastructure optimization (moving to more efficient cloud vendors or architectures), scale economies (spreading fixed cloud costs over more customers), product mix shift (shifting customers to higher-margin features or tiers), pricing improvements (raising prices while maintaining volume), and cost reduction (finding cheaper ways to deliver the same product).

Infrastructure optimization is the most common gross margin driver in SaaS. Early in a company's life, you might use expensive cloud services because you prioritize time-to-market over cost. As you scale, you optimize—moving to cheaper cloud providers, engineering more efficient code, caching more aggressively. These optimizations compound over time.

Scale economies in cloud computing are real but have limits. Moving from 10 million API calls per month to 100 million API calls per month on the same cloud platform might reduce per-call costs by 20-30%. But there's an asymptote—you can't reduce costs below a certain threshold without switching to a completely different infrastructure approach.

Product mix shift is a subtle driver of gross margin expansion. If you launch a new feature or tier that has lower COGS and many customers upgrade to it, your blended COGS improves. This happens naturally as companies add higher-value features (which often have lower delivery costs because they're more scalable).

Pricing improvements can drive gross margin expansion if you raise prices without raising COGS. However, this is often mistaken for gross margin expansion when it's really gross margin stability. If you raise prices by 10% and this results in lower volume or higher churn, your gross margin (as a percentage) might stay the same or even decline, but your gross profit per remaining customer might increase.

The ideal path is sustained gross margin expansion of 1-2 percentage points per year. This indicates that your cost structure is improving as you scale. If gross margin stays flat or declines as you scale, investigate the root cause. It might be that you're offering lower-margin products, that you're expanding into markets with higher delivery costs, or that you're making conscious choices to invest in features that reduce COGS.

A word of warning: Don't optimize for gross margin expansion at the expense of growth. Some companies cut corners on customer success or product quality to improve gross margins, and the damage to retention often outweighs the benefit of margin expansion. The goal is to expand margins while maintaining or improving retention and growth.

Chapter 22: Contribution Margin vs Gross Margin vs Operating Margin

These three metrics form a hierarchy: Contribution margin is the smallest (most conservative). Gross margin is middle. Operating margin is the largest and most encompassing. Understanding the relationship between them is critical to understanding your unit economics.

Contribution margin = Revenue minus variable COGS (only the costs that scale with customer count). This is the profit available to cover fixed customer acquisition costs and operating expenses. For a SaaS company with 75% gross margin but 50% contribution margin (because of customer success costs), contribution margin is the more honest metric. It tells you the profit you actually have to work with.

Gross margin = Revenue minus all COGS (variable costs + fixed costs that scale with customer count). This is the profit available after all customer-facing delivery and support costs. For many companies, gross margin is close to contribution margin because there aren't many fixed costs that scale with customer count. For others, the gap is large.

Operating margin = Revenue minus all operating expenses (COGS + Sales + Marketing + R&D + General Admin). This is the true bottom-line profit. Operating margin is the ultimate test of whether your business works. Companies with negative operating margins are not sustainable.

The relationship between these metrics tells you about your cost structure. A company with 75% gross margin but 20% operating margin is spending 55% of revenue on sales, marketing, R&D, and overhead. A company with 75% gross margin and 50% operating margin is much more efficient. The latter company is generating more profit per dollar of revenue.

Contribution margin is useful for evaluating the efficiency of your core product delivery. Gross margin includes some scalability assumptions (that customer success costs decline as a percentage of revenue). Operating margin includes all your costs and tells the true story.

As your company scales, the relationship between these metrics should improve. Contribution margin should stay flat or improve (per-customer delivery costs should decline or stay flat). Gross margin should improve (fixed delivery costs are amortized across more customers). Operating margin should dramatically improve (fixed R&D and admin costs are amortized across more revenue).

If contribution margin is declining as you scale, you have a serious problem. It indicates that the cost to serve is increasing. This might be because you're acquiring lower-quality customers (requiring more support), or that you're adding expensive features, or that your market is becoming more competitive and you're forced to offer more support to retain customers.

PART VI: PAYBACK AND EFFICIENCY

Chapter 23: CAC Payback Period—The Metric That Determines Your Burn

CAC payback period is the number of months it takes for the contribution margin from a customer to equal the CAC. The formula is: CAC divided by (Monthly Contribution Margin). If CAC is $1,000 and monthly contribution margin is $100, payback period is 10 months.

CAC payback period is the most important metric for determining how aggressively you can grow before running out of capital. If payback period is 12 months and you acquire 100 customers a month, you need to fund $1.2 million of acquisition costs upfront (100 customers times 12 months). If payback period is 4 months, you need to fund only $400k. Shorter payback period means you can grow faster on the same capital.

The benchmark for CAC payback period is: Less than 12 months is excellent (allows for aggressive growth). 12-18 months is acceptable for venture-backed companies (still allows for growth but requires more capital or profitability). 18-24 months is concerning (requires significant capital for growth, difficult to achieve profitability). More than 24 months is terrible (the business model likely doesn't work).

However, the benchmark depends on your business model. A direct sales company might have a 24-month payback period because of the high cost and long sales cycle. A self-serve SaaS company should have a 6-12 month payback period. A marketplace might have a 3-6 month payback period. The benchmark is relative to your business model.

CAC payback period is the metric that determines whether growth is sustainable. A company with a 6-month payback period can be very aggressive about growth. A company with a 24-month payback period must be conservative about growth because the math doesn't work. This is why early-stage founders obsess over payback period—it determines the growth trajectory the company can sustain.

Improving CAC payback period is one of the highest-leverage improvements you can make. A 20% improvement in CAC payback period (from 12 months to 10 months) might seem small, but it allows for significantly more aggressive growth because you need less capital to fund that growth.

CAC payback period improvement comes from two sources: reducing CAC or increasing monthly contribution margin. Reducing CAC typically means improving marketing efficiency or shifting to lower-CAC channels (moving from direct sales to self-serve, for example). Increasing monthly contribution margin typically means raising prices, reducing COGS, or improving retention. The latter is typically easier.

The ideal path is: Start with a 12-18 month payback period. Improve to 10-12 months in year one or two. Improve to 8-10 months as you scale. By $10M+ ARR, aim for 6-9 months. This trajectory indicates improving unit economics as you scale.

A word of caution: Don't sacrifice LTV for shorter payback period. A company that improves payback period by reducing product quality or cutting corners on onboarding might achieve shorter payback in the short term, but churn will increase and LTV will decline, creating bigger problems later.

Chapter 24: The Magic Number and SaaS Sales Efficiency

The Magic Number is a metric that measures how efficiently you convert Sales and Marketing spending into ARR. The formula is: (Current Quarter ARR - Prior Quarter ARR) / (Prior Quarter S&M Spend). A Magic Number of 1.0 means you generated $1 in new ARR for every $1 you spent on S&M in the prior quarter.

The Magic Number is useful because it's comparable across companies. A company with $10M ARR and a Magic Number of 0.75 is more efficient than a company with $50M ARR and a Magic Number of 0.5. The absolute size of the company doesn't matter; the efficiency of your S&M spending does.

The benchmark for Magic Number is: 1.0+ is excellent (very efficient S&M spending). 0.75 is good (efficient enough to support growth with venture capital). 0.5 is acceptable but concerning (takes more time and capital to grow). Below 0.5 is bad (the S&M spending is not producing enough revenue to justify itself).

However, Magic Number varies by stage. Early-stage companies often have lower Magic Numbers because they're still finding their S&M playbook. Growth-stage companies have higher Magic Numbers because they've optimized their playbooks. Mature companies might have lower Magic Numbers because they've exhausted easy growth opportunities.

Magic Number also varies by business model. Self-serve SaaS might have a Magic Number of 0.75-1.5 (very efficient marketing). Direct sales SaaS might have a Magic Number of 0.3-0.75 (lower Magic Number because of long sales cycles, but potentially higher CAC payback). The comparison only makes sense within the same business model.

A limitation of Magic Number is that it can be manipulated by changing the timing of revenue recognition or S&M spending. A company might push revenue into the next quarter to make the current quarter's Magic Number look better. Or they might shift S&M spending across quarters. Be cautious about trusting Magic Number without understanding the details.

The relationship between Magic Number and growth is important. A company with Magic Number of 1.0 and $1M in annual S&M spending might grow by $4M in ARR annually. The same company with Magic Number of 0.5 might grow by $2M. If the company needs $4M growth to hit its targets, it needs to either improve Magic Number or increase S&M spending.

Improving Magic Number comes from improving either CAC or LTV. Reducing CAC (becoming more efficient at S&M) improves Magic Number. Improving retention or expansion (improving LTV) improves Magic Number by extending the period over which you recognize the benefit of the S&M spending.

Chapter 25: Burn Multiple—The Best Efficiency Metric Nobody Uses

Burn multiple is the relationship between gross burn (how much capital you're spending each quarter) and net new ARR (how much revenue you're adding each quarter). The formula is: Gross Burn / Net New ARR. A burn multiple of 1.5 means you're spending $1.50 in capital for every $1 of new ARR you generate.

Burn multiple is superior to Magic Number because it includes the entire cost structure of the company, not just S&M. A company might have a high Magic Number (efficient S&M spending) but high overall burn (because of expensive R&D or overhead). Burn multiple reveals the true efficiency of your entire organization.

The benchmark for burn multiple is: 1.0 or less is exceptional (you're spending $1 or less for every $1 of new ARR). 1.5 is good (reasonable capital efficiency). 2.0 is acceptable for early-stage venture companies (but less efficient). 3.0+ is bad (you're burning too much capital to generate revenue growth).

Burn multiple is the key metric that determines how long your runway is and how much capital you need to raise. If you're adding $500k in new ARR per quarter and your burn multiple is 1.5, you're spending $750k per quarter on the company. If you have $10M in capital, you can sustain this for 13 quarters (about 3.25 years) before running out of money. But you need to be trending toward profitability before the capital runs out.

The ideal path for burn multiple is: Start at 2.5-3.0 as you find product-market fit and build team. Improve to 2.0 as you scale and achieve some operational efficiency. Improve to 1.5 by $10M ARR. Approach 1.0 by $25M+ ARR. Below 1.0 means you're generating more than one dollar of ARR for every one dollar of capital you spend—you can grow indefinitely.

Improving burn multiple comes from two sources: reducing burn (becoming more efficient at spending) or increasing net new ARR (generating more revenue). Most companies focus on reducing burn, which is correct, but the leverage is in increasing revenue faster. A company that reduces burn by 10% while revenue growth is flat is getting incrementally better. A company that increases revenue by 20% while maintaining constant burn is dramatically improving burn multiple.

A critical insight: Burn multiple predicts whether your company will raise another round successfully. Investors want to see improving burn multiple. If your burn multiple is static or worsening, you're signaling that your business is not becoming more efficient at generating revenue relative to capital spend. If your burn multiple is improving, you're signaling that your unit economics are improving and the company is on track for eventual

profitability.

Burn multiple is also useful for understanding which companies will achieve profitability. A company with burn multiple of 1.5 and $10M raised needs about $15M net new ARR to be profitable (if current burn is $1.5 * ARR). A company with burn multiple of 3.0 needs about $30M net new ARR. The math determines who can achieve profitability at reasonable scale.

Chapter 26: Rule of 40 and When It Starts to Matter

The Rule of 40 is simple: Growth Rate (%) + Operating Margin (%) should equal at least 40 at healthy public SaaS companies. A company growing 30% with 10% operating margin scores 40 and is considered healthy. A company growing 40% with 0% operating margin also scores 40. A company growing 50% with 0% operating margin scores 50 and is not hitting the Rule of 40.

The Rule of 40 is a heuristic for mature, public SaaS companies. It's not meant to apply to early-stage companies. A five-year-old company that's growing 20% and has -10% operating margin (score of 10) is in trouble and needs to improve either growth or margins. A five-year-old company that's growing 50% and has -10% operating margin (score of 40) is acceptable—growth is compensating for negative margins.

The Rule of 40 becomes relevant when a company approaches $20-30M ARR and starts to face the profitability challenge. Early-stage companies don't need to care about Rule of 40 because they're not close to profitability yet. The rule is useful for companies that need to balance growth and profitability.

The power of the Rule of 40 is that it forces a choice. If you have limited resources, you can choose to invest in growth (get to a higher growth rate, accept lower margins) or profitability (cut costs, accept lower growth). The Rule of 40 says both are valid—it's the combination that matters.

Companies often discover that they can't hit both high growth and high margins simultaneously with their current business model. If growth is constrained to 20% and margins are stuck at 0%, the only way to hit Rule of 40 is to improve margins to 20%. This is achievable through operational improvements, but it requires deliberate effort.

The Rule of 40 also applies in reverse. A company with 30% operating margin can sustain 10% growth and still hit Rule of 40. A company with 50% operating margin can sustain 0% growth (steady-state business) and still hit Rule of 40. High margins create room for lower growth.

One critical insight: The Rule of 40 is not a target for early-stage companies. It's a diagnostic tool for mature companies. A Series B company trying to hit Rule of 40 is missing the point. The goal is to reach profitability eventually, not to optimize the mix of growth and profitability today. Use Rule of 40 as a gauge of whether you're on the right trajectory, not as a constraint on your decisions.

PART VII: ADVANCED TOPICS

Chapter 27: Unit Economics for Marketplaces (GMV, Take Rate, Both Sides)

Marketplace unit economics are fundamentally different from typical SaaS because there are two sides of the marketplace—supply and demand—and each has different unit economics. Uber's unit economics for drivers are different from Uber's unit economics for passengers. Airbnb's unit economics for hosts are different from Airbnb's unit economics for guests. Understanding both sides separately is critical.

Gross Merchandise Value (GMV) is the total dollar value of transactions on the marketplace. If Uber processes $10 billion in rides per year, GMV is $10 billion. GMV is not revenue. Uber's revenue is the take rate (the percentage of GMV) multiplied by GMV. If Uber's take rate is 30%, revenue is $3 billion.

The unit economics of the demand side (passengers or guests) are familiar—they're similar to typical SaaS unit economics. CAC for a passenger, LTV based on frequency and spend, retention based on repeat bookings. The unit economics of the supply side (drivers or hosts) are less familiar but equally important.

For the supply side, the relevant metrics are: How much revenue does each provider make through the marketplace? How much does it cost to acquire a provider? How long do providers stay on the platform? For Uber, drivers might make $5,000 per month on average, acquire cost might be $300, and average lifetime might be 18 months. This means provider LTV is $5,000 * 18 = $90,000.

The marketplace unit economics depend on balancing the two sides. If supply is expensive to acquire and doesn't stay long, the marketplace has to charge higher take rates to cover acquisition costs. This makes the platform more expensive for demand, which might reduce demand volume. This is the marketplace balance problem that every marketplace struggles with.

Many marketplaces discover that one side has better unit economics than the other. Airbnb found that host acquisition was cheaper and host lifetime value was higher than guest acquisition and guest lifetime value. This

should inform your strategy—invest more in the side with better unit economics.

Take rate is the critical lever for marketplace profitability. A low take rate (10%) allows the platform to scale demand easily but makes it hard to be profitable. A high take rate (40%) allows the platform to be profitable but makes the platform expensive for the other side. The optimal take rate balances the unit economics of both sides while achieving profitability.

Network effects create a virtuous cycle in marketplaces: More supply attracts more demand. More demand attracts more supply. A marketplace that's able to get one side to critical mass can then attract the other side cheaply. But both sides need to be present for the marketplace to work. Unit economics should reflect the investment required to bootstrap the network on both sides.

Chapter 28: Unit Economics for Usage-Based Pricing

Usage-based pricing is when customers pay based on how much they use the product, not a fixed monthly fee. AWS charges per API call, per GB of storage, per compute hour. Twilio charges per SMS sent. Usage-based pricing creates a different unit economics problem than traditional SaaS.

The challenge with usage-based pricing is that revenue is harder to predict. You don't know in advance how many API calls a customer will make. This means CAC payback is harder to calculate, LTV is harder to forecast, and unit economics are more volatile. However, usage-based pricing aligns incentives—customers pay for value created—which often leads to better retention.

The correct approach to usage-based pricing unit economics is to segment customers by usage profile. You'll find that some customers are power users (high usage, high revenue, low churn) while others are light users (low usage, low revenue, high churn). Calculate LTV and CAC separately for each segment. The blended metrics will be misleading.

A critical metric for usage-based businesses is Usage Expansion Rate—the percentage growth in usage per customer per year. If a customer uses 100 API calls in month one and 150 API calls in month 12, they have 50% usage expansion. Usage expansion is the equivalent of expansion revenue in traditional SaaS. It's a leading indicator of customer success and retention.

Usage-based businesses often have different retention characteristics than seat-based SaaS. Because customers only pay for what they use, they might not have the same renewal ritual as SaaS companies. A customer might reduce usage to zero without technically "churning"—they just stop using the product. You have to monitor usage reduction as a churn metric.

Freemium usage-based pricing (free tier with paid usage above a threshold) can be very effective for usage-based businesses. The free tier gets customers in the door. As they grow, they hit the free limit and have to pay. This converts usage to revenue more smoothly than annual seats.

The unit economics of usage-based pricing depend heavily on your unit cost of delivery. If you pay $1 for every $10 in customer revenue (10% COGS), you can sustain indefinitely. If you pay $1 for every $1 in customer revenue (100% COGS), you're losing money on every customer. The lower your unit cost of delivery relative to

customer revenue, the better your unit economics.

A warning: Usage-based pricing can incentivize cost-cutting that harms product quality. If you're obsessed with unit cost of delivery, you might cut features or performance that customers value. The goal is to improve unit economics while improving the product, not at the expense of the product.

Chapter 29: Negative Unit Economics—When It's OK and When It's Fatal

Negative unit economics means you're losing money on each customer—the cost to acquire and serve the customer exceeds the profit they generate. This can be intentional or unintentional. Intentional negative unit economics is a deliberate strategy to achieve scale. Unintentional negative unit economics is a sign of a broken business model.

When is negative unit economics intentional? Typically early in a company's life when you're still finding product-market fit and you're willing to lose money on each customer to build a large user base. A consumer app might offer free or subsidized service to build critical mass, planning to monetize later. A marketplace might subsidize one side to bootstrap the network effect.

Intentional negative unit economics only works if you have a clear path to positive unit economics. You might plan to improve unit economics through price increases, through product changes that increase value, through reducing delivery costs, or through changing your customer mix. But you need a clear hypothesis about how you'll fix the unit economics.

A critical timeline: You should be on a path to positive unit economics by the time you hit $10M ARR, or you're in trouble. At $10M+ ARR, negative unit economics are very hard to fix. You've built the company and habits around losing money on customers, and changing that is extremely difficult.

Unintentional negative unit economics are much more dangerous. They happen when founders haven't calculated unit economics correctly or when unit economics quietly deteriorate over time. A company might discover that their CAC is higher than their LTV, meaning they're losing money on every customer. This is fatal if not addressed immediately.

How do you detect negative unit economics? Calculate contribution margin LTV (gross margin minus direct customer-serving costs) and compare it to CAC. If LTV < CAC, you have negative unit economics. If LTV > CAC but the gap is small, you have thin unit economics that leave little room for operating costs. Both are warning signs.

Fixing negative unit economics requires addressing one of three levers: reducing CAC, increasing LTV, or reducing delivery costs. Most companies should prioritize increasing LTV (through better retention or expansion) or reducing delivery costs (through product improvements or operational efficiency). Reducing CAC by acquiring lower-quality customers often makes the problem worse in the long run.

A final note: Negative unit economics are not sustainable. A company with negative unit economics can survive as long as it has capital, but eventually the capital runs out. You must be on a clear path to positive unit

economics or the company will collapse. This is not negotiable—it's physics.

Chapter 30: How Investors Stress-Test Your Unit Economics

Experienced investors don't just look at your unit economics metrics. They stress-test them. They ask the hard questions: What happens to LTV if churn increases by 2%? What happens to CAC if you move to lower-conversion-rate channels? What happens to gross margin if your supplier raises prices? The answers to these questions determine whether your business is robust or fragile.

The first stress test is the retention assumption. Investors examine your retention curves and ask: Do these curves extrapolate into the future? Is there a cliff where retention suddenly drops? Are you measuring retention correctly? If you have 90% month-one retention but 70% month-six retention, what's the true steady-state retention? Investors want to understand whether retention is stable or deteriorating.

The second stress test is the CAC assumption. Investors ask: Is your CAC calculated correctly? Are you including all costs? How much of your CAC is dependent on yourself personally (as founder or salesperson)? If you leave, can the business still acquire customers at the same CAC? A large portion of CAC dependent on one person is a red flag.

The third stress test is channel sustainability. If 80% of your growth is coming from one acquisition channel, what happens if that channel becomes saturated or expensive? Investors want to see that you have diversified acquisition channels or that you're building toward diversification. A company that depends on a single channel is high-risk.

The fourth stress test is pricing and competition. If a competitor enters your market and undercuts your price by 20%, what happens to your LTV and CAC? If you need to drop prices to compete, your margins drop and your unit economics deteriorate. Investors want to understand whether your unit economics are defensible or whether they depend on lack of competition.

The fifth stress test is market size. Investors want to understand whether the total addressable market is large enough to support the growth you're projecting. If you're a SaaS company serving accountants, how many accountants are there in the world? If your addressable market is 100,000 people, you can grow to $50M ARR (assuming $500 ACV) but not much beyond. If your market is smaller, you'll hit a ceiling.

The sixth stress test is macro sensitivity. What happens to your business if the economy enters a recession? If customers become more price-sensitive or more conservative with spending, does your LTV drop? Does your CAC increase because customers are harder to sell to? Investors want to understand whether your business is recession-resistant or vulnerable.

The questions investors ask during stress tests are not about getting you to say what they want to hear. They're about understanding whether you deeply understand your own unit economics and whether you've thought through failure scenarios. If you have thoughtful answers to stress tests, investors will be more confident. If you have no answers, it signals that you haven't thought deeply about unit economics.

PART VIII: THE UNIT ECONOMICS DASHBOARD

Chapter 31: Building the Dashboard That Tracks Everything

A unit economics dashboard is not a vanity project. It's the central nervous system of your company. It tells you whether the business is healthy or sick. It guides every major decision about pricing, hiring, and strategy. Without a unit economics dashboard, you're flying blind.

The core metrics on your dashboard should be: Revenue (monthly), CAC (total and by channel), LTV (total and by segment), CAC payback period, retention (logo and revenue churn), gross margin, contribution margin, operating margin, and burn multiple. These metrics tell you the complete story of your unit economics.

Beyond the core metrics, add leading indicators: Activation rate (percentage of new customers that become active in the first month), expansion revenue rate (percentage of customers that expand spending in the last 12 months), and magic number (quarterly revenue growth / prior quarter S&M spend). Leading indicators tell you about customer success and unit economics before they show up in retention or LTV.

Your dashboard should also include cohort-based metrics: Retention curves by month, CAC by acquisition month, LTV by acquisition month. Cohort-based analysis reveals trends that blended metrics miss. You'll see when retention started to decline or when CAC started to increase.

Segment your metrics by: customer size (SMB, Mid-Market, Enterprise), geography (US, EU, APAC), acquisition channel (organic, paid search, direct sales, partner), and cohort (when the customer was acquired). This granular segmentation reveals which parts of your business are healthy and which are sick.

Your dashboard should have "traffic light" indicators: Red (metric is below healthy threshold), Yellow (metric is declining or concerning but not yet critical), Green (metric is healthy). This makes it easy to spot problems at a glance. If CAC is red, you know to investigate. If retention is yellow, you know to increase attention.

Update your dashboard monthly. Some metrics (revenue, CAC) can and should be updated in real-time or weekly. Other metrics (LTV, retention) require more time to mature and can be updated monthly. The key is

consistency—update on a predictable schedule so you can track trends.

Share your unit economics dashboard with your entire leadership team and with your board. Unit economics should not be a private obsession of the CEO. Everyone in the company should understand unit economics and how their work contributes to the metrics. This alignment is what enables a company to improve unit economics—everyone is rowing in the same direction.

Chapter 32: The 15 Most Common Unit Economics Mistakes

Mistake #1: Calculating CAC without including salary costs. CAC should include the fully-loaded cost of your sales and marketing team, not just media spend. If you have $500k in media spend and $1 million in salaries, your CAC includes both.

Mistake #2: Using blended CAC instead of segmented CAC by channel. Blended CAC averages together channels with very different efficiency. Segment your CAC by channel to understand which channels are working.

Mistake #3: Calculating LTV without accounting for churn. LTV = ARPU / churn. If you ignore churn, you'll overestimate LTV and make overconfident decisions about how much to spend on acquisition.

Mistake #4: Including marketing and sales costs in CAC but not in LTV. CAC should be the cost to acquire. LTV should be the profit you make from the customer. Don't double-count by including costs in both.

Mistake #5: Calculating gross margin without understanding what COGS is. COGS includes only variable costs, not fixed costs. Include salaries, rent, and overhead in operating expenses, not COGS.

Mistake #6: Confusing contribution margin with gross margin. Contribution margin is narrower (only direct variable costs). Gross margin includes scalable costs. Know which metric you're looking at.

Mistake #7: Using formula-based LTV instead of cohort-based LTV. Formula-based LTV (ARPU / churn) makes assumptions about steady-state behavior. Cohort-based LTV tracks real customer behavior. Use cohort-based.

Mistake #8: Calculating CAC payback period without segmenting by cohort. CAC payback should be calculated separately for each acquisition month's cohort. Overall CAC payback can hide improving or deteriorating efficiency.

Mistake #9: Ignoring revenue churn in favor of logo churn. Logo churn is easier to understand but revenue churn is more important. A company can have high logo churn but stable revenue if the churned customers are small.

Mistake #10: Using NRR without understanding the GRR underneath. High NRR can mask high churn if expansion revenue is strong. Understand GRR and NRR separately.

Mistake #11: Trusting unit economics that are based on incomplete data. If you've only been in business for 6 months, you don't have enough data to calculate true LTV. Use provisional metrics but acknowledge the uncertainty.

Mistake #12: Calculating unit economics at the company level instead of by segment. Blended metrics hide profitable segments and unprofitable segments. You need to segment by customer size, geography, and acquisition channel.

Mistake #13: Not comparing your unit economics to benchmarks for your business model. Every business model has different unit economics benchmarks. Compare yourself to companies in your category.

Mistake #14: Focusing on one metric instead of the full stack of metrics. CAC matters, but it matters in context of LTV, retention, and gross margin. Focus on how the metrics interact.

Mistake #15: Not tracking trends in unit economics. Absolute numbers matter less than trends. A CAC that's 5% higher than last quarter is concerning. A CAC that's 2% lower is positive. Track trends month-to-month and quarter-to-quarter.