

PERSPECTIVES

Why Gross Margins Matter

By [Villi Ilchev](#) on November 21, 2019



Gross margin is a very important metric for Software as a Service (SaaS) companies. It allows startups to fund large investments in product and sales during periods of rapid growth and be profitable when growth slows. Many factors contribute to a company's ability to maintain high gross margin, including pricing discipline and power, a product that delivers high ROI for the customer, efficient and scalable infrastructure, and an easy to use product that requires little ongoing support by the vendor, to name a few. Gross margin has a significant impact on a company's ability to invest in R&D, sales, and marketing, which may ultimately determine the winner in a competitive market. It is also an important valuation driver, which is why I am often surprised how little attention companies pay to gross margin in SaaS businesses. From what I've seen, founders have little appreciation of why gross margin matters until a startup reaches some scale. Venture capitalists often ignore it. Even public investors seem to overlook the importance of gross margin (though, not for long). In this post, I wanted to provide some additional insight on the impact gross margin has on a SaaS business.

Gross Margins Are Sticky

It turns out gross margin is really hard to improve. Startups often naively assume that with scale, gross margin will improve, and are surprised a few years later when they realize there is very little in their control to move margins. In SaaS, reaching scale counterintuitively does not provide much leverage, but oftentimes puts downward pressure on gross margin as the complexity of running massive multitenant apps increases. This is certainly the case for public SaaS companies, which by the time of IPO are already locked into their gross margin profile. The chart below illustrates the point, by showing gross

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