FORECASTING THE COSTS AND VALUE OF YOUR CUSTOMERS

Overview

Now that you have completed the *10,000 Women* course, **Fundamentals of Financial Planning**, you will have the knowledge necessary to build financial forecasts for your business.

To support you further, this document expands on the forecasting guidance you have received so far. You will consider how you can forecast your profit based on the cost and value of your average customer.

Calculating the lifetime value (LTV) of your customers can help you predict the success of your business in the long term. The LTV calculation indicates the average profit you could make over the course of a customer's lifetime – or the period of time that they will engage with your business. Whilst there are many different versions of how to calculate LTV, this guide demonstrates a simple calculation that can help you think strategically about your finances as your business grows.

This guide also explores the cost of customer acquisition (COCA), or how much it costs your business to acquire an average customer. Again, like the LTV calculation provided here, this is also a simplified version that can support any business leader, regardless of their abilities in finance and accounting.

When combined, LTV and COCA can enable you to see if you are making enough profit per customer.

Calculating the lifetime value (LTV)

There are a number of ways that lifetime value (LTV) can be calculated, depending on the information available and the complexity required. One simple method of calculating a customer's lifetime value is to use net present value (NPV). NPV is how much profit you can expect to make over a period of time. The length of time a customer will engage with your business will vary depending on your business, but the following examples will use a five year period. Therefore, the LTV is the profit you expect to make from a customer over five years.

Here, profit is key, not revenue. In your calculations, you must take into consideration the various costs that incur for each customer.

Including risk
The key element to include in these calculations is risk.

Consider a large group of customers:

- Some might leave after the first year.
- Some stay a few years.
- Others stay on a longer-term basis.

These considerations need to be included in your calculations. However, calculating a LTV for each individual customer would be far too complicated and time consuming. Instead, you do one calculation for an 'average' customer, but reduce the amount of profit they make you each year (to reflect that there will be fewer customers still using your business at that time).

In these calculations, you include this risk by estimating the percentage chance that they leave each year, and multiplying this by the yearly profit. For example, if there is a 50% chance they will leave after Year 1 (as half of your customers will only stay one year), you can imagine having two customers: one who pays for two years and one who only pays for one. This means that, on average, every customer pays for 100% of the first year, but only 50% of the second. So, the LTV calculation can use this average to make estimates over multiple years, based on simple numbers.

Calculating in this way for an average customer means that you can then generalize this average to larger amounts of customers to predict overall profits (the LTV).

When calculating LTV for a new business, it is useful to overestimate the risk of losing a customer to avoid making unrealistic projections. Potential investors are more likely to be interested in helping you fund your business if your LTV calculations carefully include the potential risks and losses.

Example: Leah
To demonstrate how a very simple version of LTV calculation works, explore the example below of Leah's business model where her company provides IT support to accounting firms.

Leah's business receives $1,000 per month per organization, which is paid upfront every year. The risk of losing a customer is considered through the subtraction of 50% of the profit each year (known in LTV calculations as a 'discount').

The table below shows how this calculated by year. The top line shows a customer in the business for five years, and the profit for each year remains at $12,000. The Discounts line shows the percentage discounted, based on a 50% reduction in profit from that customer each year.

In the first year, the customer generates the full $12,000 of profit, as no discount has been applied. In the second year, they generate 50% of that profit ($6,000). In Year 3, they generate 50% of the previous year's profit ($3,000).

DESCRIPTION	Y0	Y1	Y2	Y3	Y4	Y5	LTV
Annual service and software contract ($1k per month)	12,000	12,000	12,000	12,000	12,000	12,000	
Discounts (%)		50%	50%	50%	50%	50%	
NPV ($)	12,000	6,000	3,000	1,500	750	375	$23,625

A customer who stays loyal to Leah's business and pays their $1,000 monthly subscription for five years will result in a LTV of $23,625.

For Leah, this means that one single organization in her portfolio of customers can yield approximately double what they are worth for just one year. This is really important, because it can highlight to Leah where potential 'drop off' points can be. Therefore, she can focus on how to retain the customers she has. Although, if that is not possible, she can at least see the trends and plan her resourcing accordingly.

For investors, they can also see how healthy the business is now and in the future. By providing these types of calculations that take into account discounting, investors can see that the entrepreneur has not over-estimated the amount of money they can bring in, which is a common flaw when seeking investment.

Cost of customer acquisition (COCA)

An important comparable value to the LTV is the cost of customer acquisition (COCA). The cost of customer acquisition is a straightforward calculation that establishes how much money you have to spend (e.g. marketing etc.) to acquire one new customer. This is very important because you can use this to understand the short to long-term costs that you might incur.

This can be worked out simply using the following calculation:

$$\text{COCA} = \frac{\text{Total marketing and sales expenses related to acquiring new customers}}{\text{Total customers acquired}}$$

As previously mentioned, this is a simple version of the calculation. However, more sophisticated calculations that include more variables are available.

COCA does not include any R&D costs, but it does include all elements of marketing and sales. These could be travel costs to attend a tradeshow, or the salaries of marketing staff. Make sure you include everything that is an associated and direct cost within your marketing and sales budget.

Comparing your LTV and COCA

Comparing your LTV with your COCA can give you an idea of how much profit you can make from your target market, and how much you should invest in customer retention strategies.

This is often written as a ratio:

COCA:LTV

Ideally, your LTV will be significantly higher than your COCA, which means more money is coming into the business than is going out in acquiring and maintaining customers. If this is not the case, you are not getting enough profit from that customer to justify the cost of acquiring them. A good COCA to profit ratio would be 1:3. If you are making three times as much profit as you are spending on customer acquisition, you have a good business model.

If your COCA is too high, it is unlikely that you will make money, no matter how high your sales volume may be. After reading this document you may have found that your COCA is higher or too close to your LTV. This should not cause you to panic. Instead, look through your business and use the resources from *10,000 Women* to help you make strategic decisions on key areas of your business, for example:

- Is this the right market?
- Do I truly know my customer?
- Am I reaching my target audience in the right ways?
- Are those expenses for marketing and sales needed?
- Am I doing too much or not enough?

Simple questions like these, and others brought out from your action and business planning on the courses, should help you to understand how you might achieve a better balance between your COCA and LTV.

As your business and processes mature, and you become more efficient, your COCA should decrease over time. However, you should expect it to be higher in the early stages of your business as you incur the cost of establishing business and carrying out intensive marketing. This is true for start-ups, but also if you are launching any new product and/or service, even if you are an established business.

Next steps

As you grow your business, you will find it useful to think about forecasting customer LTV. If you haven't done so already, you may also wish to complete the *10,000 Women* course, **Fundamentals of Funding**, which will support you in considering financial opportunities to fund your business growth.