ARR Vs. MRR - Choosing the right metric for your SaaS business

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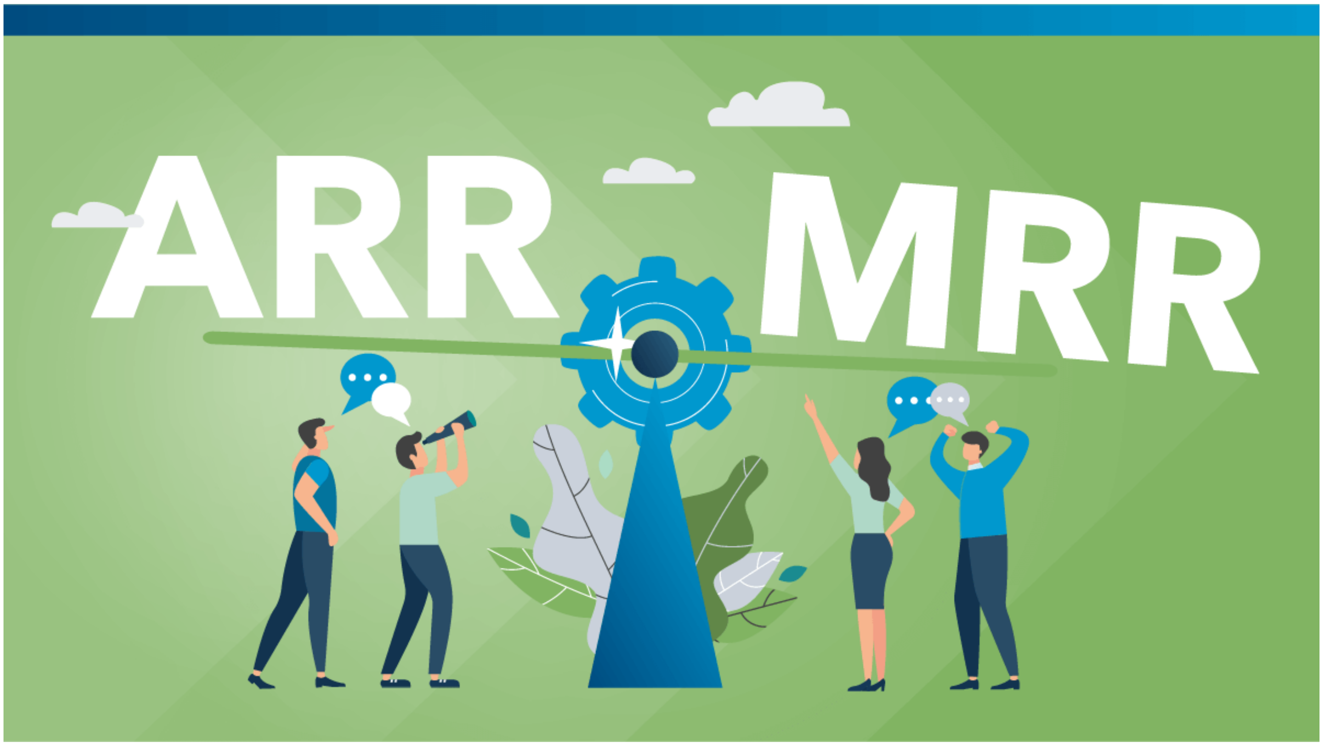

MRR (Monthly Recurring Revenue) is possibly the most important metric for a SaaS company. ARR (Annual Recurring Revenue or sometimes used to refer to Annualized Run Rate) is a related metric but with important differences. Let's dive deeper into MRR and ARR and consider which one of them to use and when.

What is the difference between ARR and MRR?

While ARR and MRR are similar, the difference between the two lies in the finer points:

- ARR provides an overall view of your business, while MRR takes a more in-depth look
- ARR assesses the success of your company in the long term, while MRR gives you insights into your short-term operational efficiency
- ARR is more suitable when subscribers sign multi-year deals. MRR is more applicable to new startup companies or those that sign monthly subscribers.

What is MRR?

MRR stands for Monthly Recurring Revenue. It is a normalized metric that tells you the average revenue you can expect to earn in a month from paying customers. A SaaS business that uses a subscription model does not depend on one-time sales as a productbased company does. Instead, its business model depends on a steady income stream from subscribers (both new and existing). The product should provide a sufficient value for customers to continue paying month after month.

New customers keep signing up (new MRR), and existing customers leave (churn out) in a subscription business. This happens continuously. Thus, the MRR keeps changing. The month-to-month MRR trend is a barometer of business health.

Who is it for?

MRR is suitable for companies whose customers sign monthly subscriptions. It is also beneficial for companies at a nascent (early) stage because it helps them tweak their operations and products faster and grow more rapidly.

Importance of MRR for your SaaS business

Monthly trends: The MRR is very important for SaaS companies because it provides monthly trends. A month is enough to assess the performance of a company.

Financial planning: The MRR is a predictor of monthly revenue, so you can use it for financial forecasting and planning. It enables you to estimate upcoming cash flow.

Growth and momentum: It’s suitable for assessing the growth rate and momentum of the company. If the MRR is steadily rising, the company is doing well. If it is falling, you need to take corrective measures, like reducing churn.

Focus on high-value clients: MRR helps you calculate the Customer Lifetime Value (CLTV) for all your clients. You can focus on the most valuable clients, provide them good value, and make it hard for them to leave you. It’s cheaper to retain and upsell existing customers than acquire new ones (this is the Customer Acquisition Cost or CAC).

MRR Calculation Formula

The basic formula for calculating the MRR is:

> MRR = ARPU X Number of subscribers

ARPU (Average Revenue Per Unit) is the payment that subscribers make each month. Consider this example. A SaaS business has 25 subscribers, and each subscriber pays $100 a month. Then the ARPU is $100. And the MRR is:

> MRR = ARPU X Number of subscribers = 100 X 25 = $2500.

One complication is that all subscribers may not pay the same fee. The fee difference could be because of discounts, add-ons, different usage levels, or different subscription packages.

Let’s look at another example.

Assume that the business has 10 subscribers paying $150 per month and 15 subscribers paying $100 per month. Then,

> MRR = (10 X 150) + (15 X 100) = 1500 + 1500 = $3000.

What is ARR?

The ARR is the value of recurring revenue that a business earns every year from its subscribers when normalized for a year. The ARR predicts the total amount of revenue that will accrue every year.

The ARR, like the MRR, has several components which either increase or decrease it. These include the ARR gained from new sales and upgrades, retention from renewals, and revenue lost because of customer churn, cancelations, and downgrades.

Who is it for?

ARR is popular with B2B companies that sell multi-year subscription plans. Note that you need neither MRR nor ARR for compliance with the GAAP, a set of Accounting Standards issued by the FASB.

Importance of ARR for your SaaS business

ARR is invaluable for:

Assessing financial health of the company: ARR shows whether total revenue is increasing or decreasing and the corresponding reasons. With this knowledge, you can focus on and improve specific areas to increase your revenue. Did you know that if your business is only growing at 20% annually, there's a 92% chance you won't exist in a few years?

Using a proven SaaS Metrics Template like ours can help you get your arms around ARR and other metrics so you can create a better plan for the future.

Budgeting: You can plan major expenses better. This includes spending on employee compensation, making key hires, spending more on marketing and sales, and purchasing or upgrading equipment.

Forecasting revenue: You can forecast revenues and cash flow more accurately. This helps to plan expenses more precisely.

Attracting investors: Companies with a good ARR attract investors and buyers. The contractual obligations to buy (and pay) over long contract terms give them confidence in the current and future performance of the company.

ARR Calculation Formula

The basic formula is simple.

> ARR = 12 X MRR

So, if your MRR is $5000, then your ARR = 12 X 5000 = $60000.

Alternately, if your business has 10 subscribers, and they have each purchased $1000 yearly subscriptions, then ARR = 10 X 1000 = $10,000.

But all your customers may not be on a 1-year contract. You may have customers who have signed multi-year contracts of differing lengths. For instance, suppose that you have:

5 subscribers who have signed a $6000 contract over 3 years, 10 subscribers who have signed a $5000 contract over 2 years, and 40 customers on a 1-year $3000 contract. Here, we will need to annualize their yearly contracts. So, the ARR would be:

ARR = 5 X (6000 / 3) + 10 X (5000 / 2) + 40 X (3000)

= 10,000 + 25,000 + 120,000

= $155,000

ARR Vs MRR: Which One Should You Use?

ARR and MRR are very similar. The big difference is the time duration for which you normalize revenues – year and month. Hence, ARR provides a long-term or “big picture” view of company performance, and MRR a shorter-term view.

Whether you use MRR or ARR depends on the kind of company and the type of customers. You should use ARR if you are an enterprise company, as most of your subscribers will be on annual contracts. You should use MRR if most of your clients pay on a monthly basis.

ARR is appropriate for your business if subscriptions last for at least a one-year period, and most customers have signed a one-year or multi-year contract.

MRR is handy for short-term planning and measuring the impact of recent changes. ARR helps predict long-term growth and what size your business can go to in the future.

Finally, when planning to sell your business, focus on the ARR. This is what buyers will look at, not the MRR.

However, the bottom line is that nothing stops you from using the key metrics of ARR and MRR.

Is ARR 12 times MRR?

The answer is nuanced. ARR is 12 times MRR when the customer base remains constant. However, as we’ve shown, MRR is prone to fluctuation. It can increase because of new customers, renewals, and upgrades. Conversely, it can decrease due to churn and downgrades. Therefore, it varies from month to month, causing the true ARR to deviate from the simple 12 times MRR formula.

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If you’re a B2B SaaS Founder already over $10K MRR, then we invite you to schedule a Growth Session with our team of Scale Specialists. You’ll walk away from this complimentary call with a Growth Action Plan customized for your SaaS business.

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