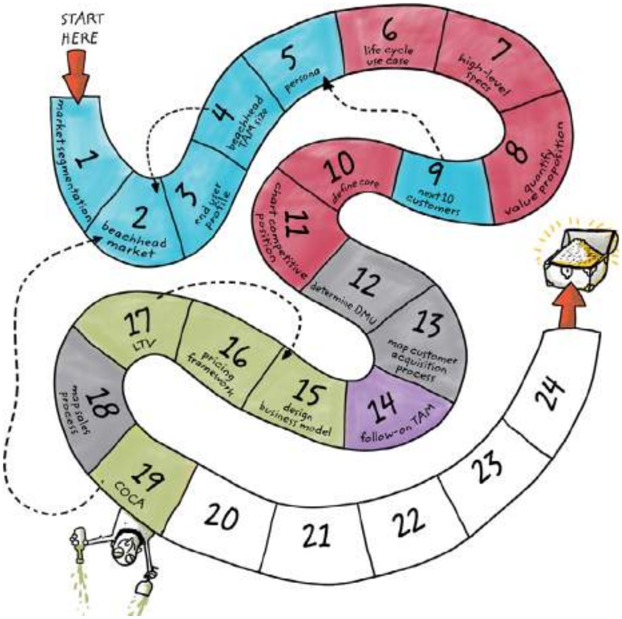
STEP 19

Calculate the Cost of Customer Acquisition (COCA)



IN THIS STEP, YOU WILL:

- Determine how much it costs to acquire a customer over the short term, medium term, and long term, based on your sales process.

We love the entrepreneurs and their optimism but it almost always blinds them to the real costs of customer acquisition. It is essential that you do realistic calculations and then make appropriate adjustments over time.

Caution: The Cost of Customer Acquisition (COCA) is an extremely important metric and can be difficult at first to understand and calculate. This step explains the COCA in detail, but you will need to pay close attention to the details to calculate it correctly. It requires a significant amount of effort and systematic thought. Do not skip or skim this step because getting COCA right is both critical and challenging.

The sales process you defined in the previous step (Step 18) directly influences your Cost of Customer Acquisition (COCA). In determining the COCA, you must quantify all the sales and marketing costs involved in acquiring a single average customer in steady state. Your COCA does not include any fixed production costs or expenses outside of the sales and marketing department, such as research and development, finance and administration, or overhead. It does include all the sales and marketing costs, even when a potential customer chooses not to purchase your product. In this step, you will calculate your COCA for three contiguous time periods, where the first time period begins with your initial sales costs.

You will refine the COCA calculation as you get farther along in the sales process. To determine your starting COCA, you must identify what factors influence your COCA, assign realistic values to the various factors, and understand what actions you can take to ensure your COCA decreases over time.

WHY COCA MATTERS

Typically, in the early stages of the sales process, the COCA exceeds the Lifetime Value of an Acquired Customer. In sustainable businesses, the COCA decreases over time until it is significantly less than the LTV. One of the key questions for your business is how long it will take for the COCA to drop below the LTV of a customer, because until you reach that point, your business is spending more money than it is taking in (Figure 19.1).

HOW *NOT* TO CALCULATE COCA: A BOTTOM-UP PERSPECTIVE

Let's say we are selling a widget with a sales cycle of half a year, and it takes one twentieth of our salesperson's work time to identify, engage, track, support, close, and collect payment for selling to

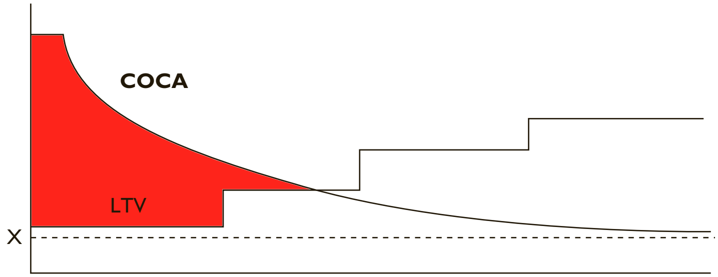


Figure 19.1 In a sustainable business, the cost of customer acquisition (COCA) will eventually drop below the lifetime value of an acquired customer (LTV). During the long-term stage of the sales process the COCA will level off, and will continue to require an ongoing investment (represented on this chart by the dotted line X), but costing less than the LTV of the customer. The LTV will often increase over time as well, due to upselling opportunities with existing customers (or "negative churn" as David Skok calls it). Pricing power will sometimes increase as well, if your product becomes a standard with little forceful competition. This graphic representation has a particularly aggressive LTV increase, which is usually not the case but it does add some drama to the chart. The red area indicates your cash burn before reaching cash-flow positive.

one customer. We pay the salesperson $150,000 per year if they make 100 percent of their quota (often called on-target earnings). For this example, we will assume the salesperson meets their quota.

Therefore, how much does it cost to pay one salesperson to acquire one customer? To determine the cost of one salesperson per sales cycle, we multiply their yearly salary by the length of the sales cycle: $150K * ½ year = $75K per sales cycle. Then, if the salesperson devotes one-twentieth of their time to closing one sale, the cost of the salesperson's salary on each sale is $75K * 1/20 = $3,750. While all of this seems logical, it does not nearly represent the actual Cost of Customer Acquisition. It's merely the cost of one component of the sale—the salesperson.

First, the calculation above does not take into consideration all the other costs associated with closing this deal. The salesperson's benefits package (health care, vacation time, 401(k), etc.) typically costs you the equivalent of 25 to 30 percent of their salary. Then there are costs for travel and entertainment, demo units, tech support, mobile phone bills, trade show expenses, marketing campaigns to generate leads, Internet data charges, and more. We could do a bottom-up analysis, painstakingly scrutinizing the receipts and invoices and assigning expenses to each customer. We also have to take into account the other expenses associated with having a salesperson: the office furniture, computer, Internet and phone charges, the cost to rent or purchase the building the salesperson works from, and more. Let's say that all these costs, added up and divided by the number of new customers equals another $2,500 per customer. So is our COCA actually $3,750 + $2,500 = $6,250? No!

Also, when we said it takes the salesperson one-twentieth of their time to close one sale, and divided the salesperson's salary for that sales cycle by 20 to get the cost per customer, we were assuming that the salesperson closes 100 percent of the sales they work on, totaling 20 sales per six-month sales cycle. This assumption is extremely unlikely because no salesperson closes every deal. If a salesperson is closing even 50 percent of the customers he engages, the person is probably getting paid much more than $150,000 per year and therefore would not be working at your company.

Even assuming a salesperson closes 25 percent of sales, which is very aggressive, meaning the salesperson is actually selling five units during each sales cycle, rather than 20. So for every one-twentieth of a salesperson's time spent on a customer who makes a purchase, another three-twentieths of the salesperson's time is spent with potential customers who do not buy. These costs have to be factored into the COCA as well.

A bottom-up analysis that factors in all these other expenses tends to get messy very quickly and can create a false sense of accuracy. In my experience, this method does not work. A completely accurate estimate of the cost to acquire one new customer is hard to project. What we can be sure of is that estimating a COCA of $6,250 would be dramatically understated, and merely the tip of the iceberg of the COCA cost. Realistically, the COCA in this example is probably closer to 10–20 times that number (Figure 19.2).

THE RIGHT WAY TO CALCULATE COCA: A TOP-DOWN PERSPECTIVE

A more effective way to calculate an accurate COCA is to tabulate your aggregate sales and marketing expenses over a period of time; then divide that by the total number of new customers you acquire within that time period. Since your COCA(t) will vary over time as your sales process changes and your organization is in the learning curve and you develop strong positive word of mouth within your target customer group, you should calculate it over time. I recommend three time periods in order to show how the COCA is trending.

Appropriate time periods depend on the life cycle of your product, which is directly related to the amount of time it takes for your customer to realize the value proposition from your product. A typical way to define the first three time periods for a COCA calculation is by taking your first year of sales, your second and third year or sales, and your fourth and fifth year of sales. Depending on your new venture, these time periods could be different. If in doubt, use year 1, years 2 and 3, and years 4 and 5 as your three time periods.

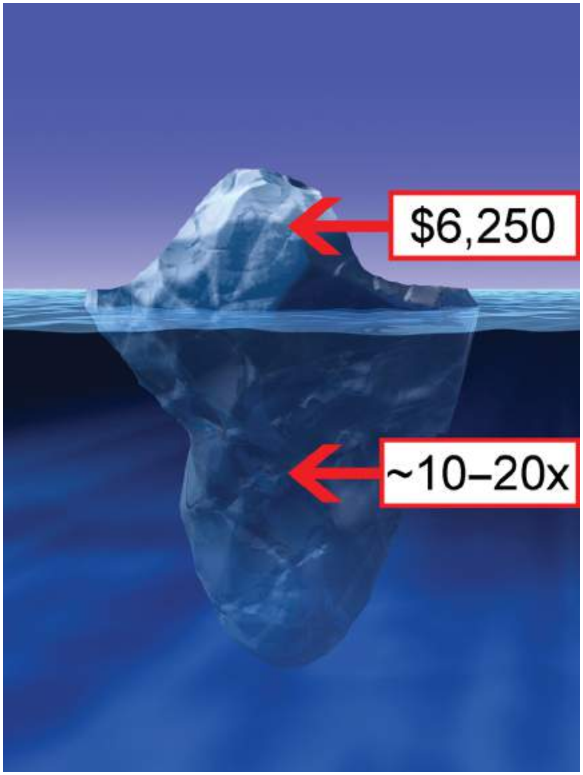


Figure 19.2 Be careful with bottom-up COCA calculations as they tend to be significant underestimations.

When aggregating your sales and marketing expenditures, be sure to include costs for all the key items in your sales and marketing plan: sales reps, auto, travel and entertainment, phone, Internet, demo units, technical sales support, website development, consultants, trade shows, real estate, administrative support, computers, and so on. Also calculate the cost in time that the executives on the team spend on sales as these are very real and expensive costs.

This calculation requires that you understand your sales process well. Do not worry if your calculation is not exactly right; but be sure to enlist an experienced person to help develop budget projections, and be sure to understand how adjusting costs affects the profitability of your business.

Dividing the cost of your sales and marketing expenses by the defined time period will yield the Total Marketing and Sales Expenses over Time or TMSE(t) where t is the first, second, or third time period. If a sizeable portion of your TMSE(t) is the cost of retention of existing customers, rather than acquiring new customers, subtract this from the TMSE(t). We will refer to the cost of retention as the Install Base Support Expense over Time or IBSE(t). Then, determine the number of new customers you will close during that time period (which means delivering the product and collecting their money), referred to as New Customers over Time or NC(t).

Given these definitions, we can explicitly define the COCA calculation for any given time period to be as follows:

$$\mathrm{COCA}(t) = \frac{\mathrm{TMSE}(t) - \mathrm{IBSE}(t)}{\mathrm{NC}(t)}$$

$$\begin{array}{c}\text{Cost of Customer} \\ \text{Acquisition}\end{array} = \frac{\text{Total Marketing and Sales Expenses}(t) - \text{Install Base Support Expense}(t)}{\text{Number of New Customers}(t)}$$

Once you have numbers for each of your first three time periods, plot them on a graph where the x-axis is time and the y-axis is COCA for that period. You can also draw a best-fit curve.

The graph in Figure 19.3 illustrates a good COCA, where it decreases over time. The horizontal line at X represents the COCA's steady state, once sales volume ramps up and the product, company, and market mature, typically achieved during the longer-term stage of your sales process.

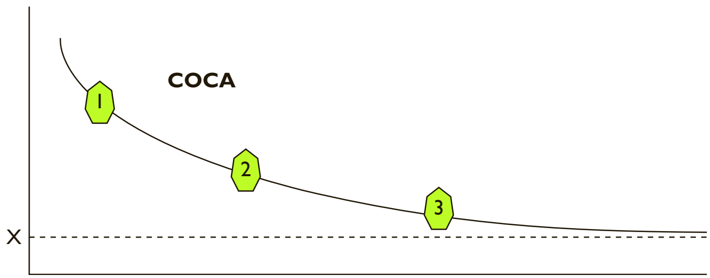


Figure 19.3 Graph of COCA over time.

HOW TO REDUCE COCA

As you can see in Figure 19.3, the COCA will almost always start at a very high point (i.e., well above the final COCA and likely higher than the LTV) because you need to first create the market. Your organization will seek ways to reduce these costs to make the business much more attractive. Here are some of the common ways this can be done.

1. **While Very Powerful, Use Direct Sales Judiciously as It Is Very Expensive:** Hiring a team to do direct sales may be necessary to start, but it is very expensive. As an alternative, consider investing instead in technological enablers, from telemarketing to having an effective web presence to engaging through social media in order to decrease costs as much as possible.
2. **Automate as Much as Possible:** Whenever possible, try to automate the customer acquisition process even if it requires significant investments. If you can promote your product through sites where there are big networks and opportunities to make your message go viral, from Facebook's and LinkedIn's network effects to Amazon.com's preference engine, these are great channels through which details about your product can be shared. You might also automate your marketing by creating incentive schemes for your users similar to the ones made famous by Avon, or the one Groupon used to reach a multibillion-dollar valuation.
3. **Improve Conversion Rates in Sales:** Always focus on improving the conversion rates from your leads. As you see in the bottom-up calculations, there is a huge cost associated with chasing deals that you don't close. Getting higher conversion rates on leads opens up the funnel so more deals get through, increasing your revenue and decreasing your COCA.
4. **Decrease the Cost of Leads and Improve the Quality of Leads:** Getting a bunch of business cards at a trade show may get you a lot of leads (less cost per lead), but they are probably poor-quality leads. You can reduce the cost of leads without sacrificing the quality of the lead with techniques like HubSpot's inbound marketing strategy. Incorporating tools and techniques into your sales process that increase the quality of your leads, and paying attention to where your leads are coming from, will improve your conversion rate.
5. **Speed through the Sales Funnel:** By focusing on the speed at which prospects are moving through the sales cycle, you can decrease the sales cycle, which will have a dramatic positive effect on reducing the COCA.
6. **Choose Your Business Model with COCA in Mind:** The design of your Business Model can dramatically affect your COCA, as Jim Dougherty learned at IntraLinks, the company

providing a secure online space for investment bankers and lawyers to share documents with their clients. His business model was based on usage, but it was hard to sell to customers because they could not easily plan how much they would spend on the product. When he switched to a "cell phone" type of model, where customers paid a fixed amount each month for an agreed-upon type of service, with the flexibility to buy additional service on a usage basis, it became much easier to sell the product to customers, and the sales cycle length decreased dramatically.

7. **Word of Mouth:** The biggest driver of reducing COCA is positive word of mouth about a company and its product. This tends to dramatically decrease the sales cycle, decrease the customer's desire to push you for discounts, and bring in well-qualified customers who already are good fits for the product, so salespeople can be much more productive in dealing with them. Many companies today, large and small, attempt to drive this by measuring it using the Net Promoter Score index and system.[1] They carefully track this and report it in their operations, executive, and even board meetings. Bonuses are tied to it with the belief, validated in real life, that this is a good proxy for the strength of word of mouth from your customers.
8. **Stay Focused on the Target Market:** Staying focused on your beachhead market from the earliest steps of this process, and not getting distracted by customers outside of your chosen market, will help improve word of mouth and also make your sales reps much more productive. They will become experts in their industry and the sales cycle length will decrease (repetitive selling to the same DMU and Process to Acquire a Paying Customer makes the sales rep much more productive), thereby decreasing the COCA.

EXAMPLES

Associated Gas Energy: Using a Direct Sales Model

Oil drilling typically produces "associated gas" as well, and dealing with its disposal is costly and problematic for the environment. Often, no infrastructure exists at the drilling site to transport the gas to where it could be sold. Associated Gas Energy was a new venture plan developed by my students to enable oil producers to transform this operating cost into profit. Using GTL (Gas To

[1] Find out more about the Net Promoter Score and System at www.netpromoter.com. It is a systematic way to measure and then drive Word of Mouth.

Liquids) technology, associated gas is converted into crude oil at a cost to the customer of $70/barrel. The customer can sell this oil at market prices. If market prices are around $100/barrel, the customer gains $30/barrel. Reinjection cost savings yields approximately $10/barrel extra for the customer.

This was a very clever idea with seemingly compelling financials; but the COCA needed to be carefully considered. The target customer was a very conservative buyer who had to be sold to with old-fashioned direct sales methods, especially at the beginning. The new venture would require a lot of missionary work to get off the ground.

It was believed that the sales cycle for this expensive product ($300K for the initial installation plus annual maintenance fees) would be about one year even though it had a compelling value proposition. The company had good technology but needed to hire an experienced salesperson as well as a tech sales support person who had credibility and understood the sales dynamics. In addition, they were going to hire a consultant the first year to help them break through the initial customer inertia to be the first to have this system (remember, this is a conservative market!) and to get all the regulatory issues taken care of that come along with energy and environmental associated projects like this. They anticipated there would be a ramp-up time for the sales rep to become effective in selling the product, and so in the first year they were realistically projecting one system would be sold. The first sale would be the hardest; after that one, they would not need the consultant again. After they had gone up the learning curve, the new venture's team would have the capability to do the selling themselves. In addition, with a successful installation as a reference, the sales cycle could be dramatically reduced.

While the COCA for the first year was very high, if the product worked the way they anticipated, they would have validated the value proposition, taken away great risk, gained a reference site, and brought their sales rep and process up to speed.

In year two, they would be able to hire a second salesperson as well as a tech support person to increase their sales. In Table 19.1 you can see how they accounted for the full marketing and sales budget and how it scales over time. Ultimately, the COCA gets down to about $150K, which is still high, but it will continue to decrease in future years.

FillBee

The team behind FillBee did an outstanding job on their COCA calculation. Their plan showed how to develop a creative, comprehensive, and actionable marketing strategy that also allowed the team to track COCA in a quantifiable manner. This was extremely well-done and represents a plan and calculation that effectively uses the tools and tactics available today to drive COCA down over time in a systematic way (Figure 19.4).

Table 19.1 Associated Gas Energy COCA Calculation (a direct sales example)

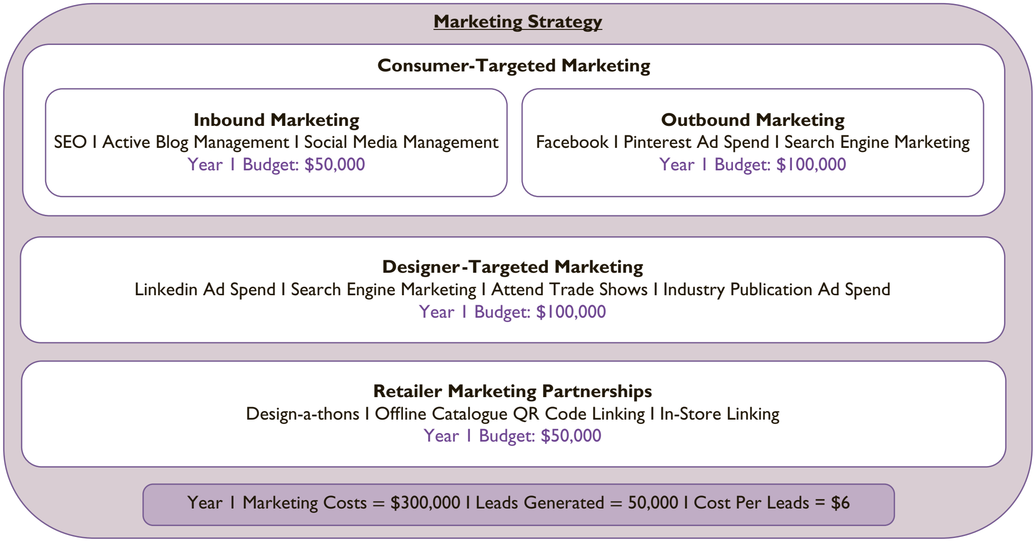
	Year		
Items from Marketing & Sales Budget	**1**	**2**	**3**
Number of Salespeople = Number of Tech Support People	1	2	3
Sales Salary ($175K/year fully burdened)	$ 175,000	$ 350,000	$ 525,000
Tech Support Salary ($125K/year fully burdened)	$ 125,000	$ 250,000	$ 375,000
Travel	$ 24,000	$ 40,000	$ 52,500
Entertainment	$ 15,000	$ 24,000	$ 30,000
Events	$ 30,000	$ 35,000	$ 40,000
Website Cost	$ 10,000	$ 10,000	$ 10,000
Consultant	$ 15,000	$ —	$ —
Total	$ 394,000	$ 709,000	$ 1,032,500
Number of Customers	1	3	7
COCA for Year	$ 394,000	$ 236,333	$ 147,500

Example of Using Benchmarking: Speakeasy

Here is another technique to determine whether your COCA is reasonable. Speakeasy's plan was to teach people how to speak more effectively via tutorials over the internet. There was to be no direct sales force; rather they would count on their target customer finding out about them through social media platforms. They had the following COCA calculation, which I thought was excellent:

> **Speakeasy Cost of Customer Acquisition**
> In determining our cost of customer acquisition we benchmarked the cost against other SaaS companies that employ inbound marketing, mainly Zynga and Groupon. We realize that our venture is not as mature as these companies but the numbers still provide a reasonable benchmark.

A detailed visualization of the Company's overall marketing strategy—including estimated costs and consumer leads generated for year 1—is displayed below:



FillBee ascribes to a technology-driven sales strategy with an aim toward dynamically optimizing the user experience. The Company focuses on delivering highly targeted content and offers to its consumers, thereby maximizing purchase conversions of both furniture and custom designs.

A detailed visualization of the Company's sales strategy and accompanying funnel is displayed below:

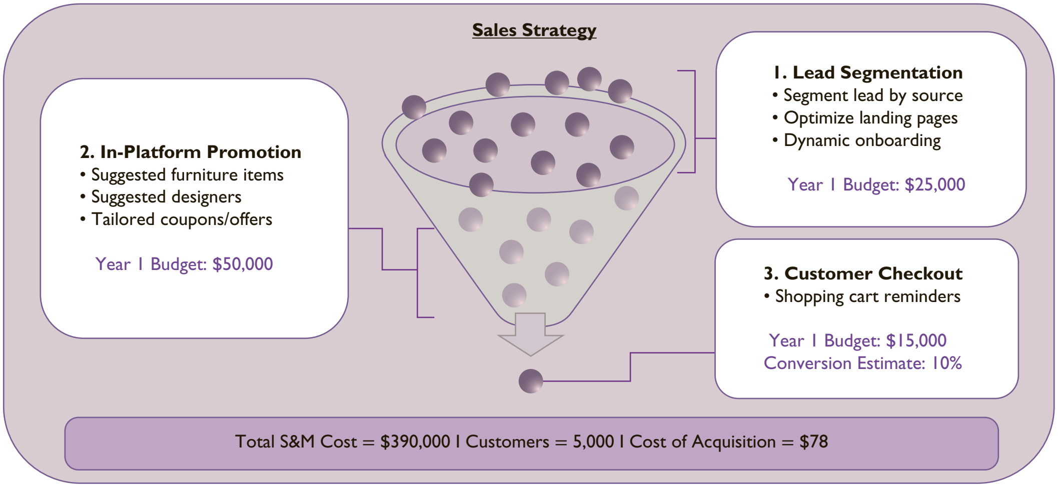


Figure 19.4 FillBee's COCA calculations.

Table 19.2 Groupon versus Zynga COCA Table

Company	COCA (2012)
Groupon	$5.40
Zynga	$0.85

Table 19.3 SpeakEasy COCA

Marketing Cost Assumptions			
	Y1	*Y2*	*Y3*
COCA/User	$1.60	$0.85	$ 0.85

As our customer acquisition strategy is more similar to Zynga's than Groupon's, we used Zynga's figures as the basis for our estimates [see Table 19.2]. Over the past quarters, Zynga's COCA has ranged from $.30 [to] $.85. To be conservative, we used the higher end of Zynga's range. Our company's COCA estimates in earlier years are higher due to an increased reliance on outbound marketing in addition to inbound. In years two and three, we will utilize a purely inbound marketing strategy and word of mouth. Lastly, we believe using per unit COCA as a driver to total marketing costs is reasonable since it allows us to provide an "apples to apples" comparison to other SaaS companies [see Table 19.3].

Example of a Way to Creatively Drive Down COCA: Dollar Shave Club

One of my favorite examples of how to potentially and creatively drive down COCA is from the company Dollar Shave Club. Founder and CEO Mike Dubin saw a significant opportunity to gain significant market share in the shaving industry by being a low-cost provider. Through eliminating middlemen such as retail stores and using a razor without fancy features, he could deliver on low cost. His value proposition for customers was not just cost, but that customers would save time by having razors delivered to them rather than going shopping. This value proposition was bolstered by his innovative business model, which applied the subscription and delivery model for the first time to the shaving industry.

All of this represented a beautiful Blue Ocean type of new product strategy, but there was still one problem. He needed to get the word out to customers, and the existing companies in the market had enormous marketing budgets that could drown him out and overwhelm him. As a new entrepreneur, he could not afford direct sales or even distributors, nor was this going to be his model. Through advertising he could try to create awareness but this would be cost-prohibitive and likely to invite a swift response from the established players. Mike's COCA was going to be too high. He needed to be creative.

So Dollar Shave Club fought back with the assets they had. Mike had a background in comedy and filmmaking and had some friends in the business. As a startup, he could create a quirky video beyond the bounds of what a company like Procter & Gamble could do. So Mike allocated the lion's share of his resources to make an outrageous and well-done 90-second video about Dollar Shave Club (Figure 19.5). Mike starts by describing the purpose of his company ("for a dollar a month we send high-quality razors right to your door") with the on-screen tagline "Shave Time. Shave Money." All is in alignment with his value proposition.

But then he starts walking toward the camera, about to create the moment that everyone will remember. He asks, "Are our blades any good?" The camera pans to a poster that answers that question, and defines the tone for the rest of the video: "No. Our blades are F**king Great." Mike continues to use humor and boldness throughout to mock current razor vendors, positioning himself

Figure 19.5 Dollar Shave Club screenshot.

to his target customer (young, digitally savvy, time-pressed urban males) as the lovable David taking on Goliath.

The video went viral immediately. The time and energy Dollar Shave Club spent on this video was probably the best money the company will ever spend. While this did not necessarily reduce COCA (because watching the video does not equate to “acquiring the product”), the video produced many very low-cost leads, and now the question is whether Dollar Shave Clubs can ultimately convert them into paying customers.

To see the final product, you can go to www.dollarshaveclub.com and use it as inspiration to think of creative ways you can reduce your COCA acquisition.

SUMMARY

At this point, you have completed the important steps of determining whether the financials of your business will work. The LTV and COCA analysis can kill many new businesses by identifying problems early in the process; but more often it highlights the importance of keeping an eye on key factors to make the business successful. It provides a simpler scoreboard than financial statements and allows you to make adjustments and refine your business. It makes your path to success more transparent. Don’t let your optimism blind you in doing the calculations. Make the numbers real and not what you want them to be.