3 Common Mistakes That Are Inflating Your Marketing Budget

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It’s a mystery. Your sales and marketing expense has been over budget for months, but you’re missing your revenue projections. You’re burning far more cash than you had projected just a few months ago. And yet, your CFO and VP of Marketing assure you that the ROI on your marketing spend is best-in-class for your industry. How can that be?

In my work with venture-backed startups seeking a path to profitability, this is a common fact pattern when I start my initial assessment of a company.

One of the most important KPIs for your business is the LTV:CAC ratio – comparing the lifetime value of a customer to the average cost to acquire that customer. The math seems straightforward enough. Customer lifetime value is the average value of orders placed over the projected lifespan of a customer. Customer acquisition costs are the sales and marketing expenses incurred to convince a customer to make that first purchase. Divide LTV by CAC, and you get a ratio that helps you determine the efficiency of your marketing spend.

Seems simple. What could go wrong? As it turns out, quite a bit, and the result is growing losses and accelerating cash burn. The problem is that several variables feed into the calculation of this ratio, and companies can get very creative when it comes down to choosing which ones to use.

How do you determine the value of an order? How long is the projected customer lifespan? Which sales and marketing costs should you include in CAC? So many decisions to make, each of which can have a dramatic impact on the result. Here are three common mistakes companies make when calculating their LTV:CAC ratio:

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1. Calculating LTV based on revenue

Sales do not equal value. I often find that a company is calculating LTV based on revenue. Instead, you should calculate your LTV based on your contribution margin by subtracting your variable production and selling costs from net revenue. That's the true value your customers are generating for your company.

2. Using a projected lifespan that extends beyond your cash runway

Should your projected customer lifespan extend for three years if you only have 12 months of cash left and no clear path to raising more money? Using a projected lifespan that extends far beyond your cash runway will increase your LTV, but it's a trap. While your marketing dollars are going out the door today, the positive ROI from that spend won't come until it's too late. You'll be out of cash before the customer even makes it to the third year of their purchase cycle.

If you want to help your team correctly determine the right measure of spending on your marketing efforts, choose a customer life span that aligns with your cash plan. You can then use a longer, more accurate lifespan when you have a clear path to extending your runway, giving you room to increase your sales and marketing budgets.

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3. Carving out expenses from CAC

Retail magnate John Wanakaer once bemoaned, "Half my advertising spend is wasted; the trouble is, I don't know which half." This quote is particularly relevant when we consider the calculation of CAC. Different layers of marketing support each other in ways that can be impossible to measure. For example, your brand marketing and PR efforts raise awareness, hopefully making your customer acquisition marketing more efficient. Your creative team, constantly testing the imagery and copy in your ads, greatly impacts the effectiveness of your advertising campaigns.

And yet, far too often, I'll see a CAC calculation that only includes the direct spend on customer acquisition. When you ignore all of the other costs associated with your marketing efforts, the lower CAC will inflate your LTV:CAC ratio, leading you to ramp up spending far beyond what your company can afford.

Fully load your CAC with all the costs associated with your marketing efforts, covering your marketing funnel from top to bottom. Don't forget to include your employees' salaries and the cost of the external agencies they have engaged.

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Get the math right first

The ideal target LTV:CAC can vary from business to business, based on your business's margin and cash flow profile. A general rule of thumb is that an LTV:CAC of 3x or more should put you on the path to profitability and positive cash flow. A lower ratio can lead to accelerating cash burn against

inflated sales that can create a downward spiral if not corrected fast enough.

A well-funded startup with high gross margins and a clear path to scalable growth might decide on a lower target for some time to grab market share. A startup with less than a year of cash in the bank had better tighten up the math and run at a higher ratio if they don’t want to run out of money. But none of that will matter if you’re not calculating the ratio correctly. Start by getting the math right, and then you can decide the target that makes the most sense for you and your team.

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