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[Essentials of Software-as-a-Service \(SaaS\) Business.](#)

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## 5.4 Company Activity Metrics - Part 2

In this video, we will explore 2 additional Company Activity metrics, Net Profit Margin and Gross Margin. Let's start with the first one.

### **Net Profit Margin**

- *Measures the efficiency of a company in converting sales into actual profit*

Net Profit Margin measures the efficiency of a company in converting sales into actual profit. It calculates the proportion of revenue that remains as profit after all operating expenses, taxes, interest, and other costs have been deducted.

This metric which reflects the company's financial health and sustainability is critically important to stakeholders, particularly investors, as they evaluate potential and ongoing investments. A robust Net Profit Margin often reassures investors that the company manages its finances well. Conversely, a declining margin serves as a warning signal that may lead investors to reconsider their investment positions.

To calculate Net Profit Margin, we take the net profit (which is the residual amount of earnings after all expenses have been deducted from sales) and divide it by the net sales revenue. Then we multiply it by 100 to express it as a percentage.

$$\text{Net Profit Margin} = \left( \frac{\text{Net Profit}}{\text{Net Sales Revenue}} \right) \times 100\%$$

Suppose our company generates 500.000€ in revenue from subscriptions over the year. Our total expenses including marketing, salaries, and other operating expenses were 300.000€. Firstly we need to calculate net profit by subtracting total expenses from the net sale revenue. The result is 200.000€. Then we can obtain the net profit margin by dividing net profit by net sales revenue.

- Revenue earned: 500 000€
- Total expenses: 300 000€

### 1. Calculating Net Profit:

$$\text{Net Profit} = \text{Net Sales Revenue} - \text{Total Expenses} = 500,000\text{€} - 300,000\text{€} = 200,000\text{€}$$

### 2. Calculating Net Profit Margin:

$$\text{Net Profit Margin} = \left( \frac{200,000\text{€}}{500,000\text{€}} \right) \times 100\% = 40\%$$

40% Net Profit Margin tells us that our company is quite efficient at converting its revenue into profit. For every euro earned from sales, we manage to keep 40 cents as profit after all expenses have been paid.

The last Company Activity metric that we will cover is called Gross Margin. This metric shows the financial health related to production costs. Let's take a look at the definition.

### **Gross Margin**

- *the difference between the revenue a company earns from its sales and the Cost of Goods Sold (COGS), expressed as a percentage of revenue*

Gross Margin measures the difference between the revenue a company earns from its sales and the Cost of Goods Sold, expressed as a percentage of revenue. By calculating this metric we can find out how much our company retains from each euro of sales after we cover the direct costs associated with producing our products or services.

Let's take a look at the formula. To calculate gross margin, we first subtract the cost directly associated with producing a product from the revenue generated from this product. Then we divide that number by the total revenue and multiple by 100 to get a percentage:

$$\text{Gross Margin} = \left( \frac{\text{Revenue} - \text{COGS}}{\text{Revenue}} \right) \times 100$$

Now we will calculate gross margin for a hypothetical SaaS company that offers a project management tool. Our company has the following financials over a fiscal year: Costs Of Goods Sold was 150,000€. This includes costs directly related to software development,

server costs, and support staff. Our revenue was 500,000€.

We start with the total revenue of 500,000€ and subtract the cost of goods sold (COGS), which is 150,000€. This subtraction gives us the gross profit which is 350 000€. Then we divide this number by the total revenue of 500,000€ and multiply the result by 100.

$$\text{Gross Margin} = \left( \frac{500,000\text{€} - 150,000\text{€}}{500,000\text{€}} \right) \times 100 = 70\%$$

The result is a Gross Margin of 70%. This means that for every euro generated in sales, we retain 70 cents after accounting for the direct costs of providing our service. This really high margin is a clear signal that our company has efficient cost management and an effective pricing strategy.

On the contrary, if our Gross Margin is low — for example, only 20% — it means we retain just 20 cents from each euro of revenue. This scenario could indicate several potential problems. Our production costs may be disproportionately high, possibly due to expensive inputs or inefficient operations. Additionally, we might be underutilizing resources, such as software licenses or staff capabilities, leading to wasted potential. Furthermore, our pricing strategy could be suboptimal; perhaps our prices are too low compared to industry averages, failing to adequately cover our costs.

To address these issues, we would need to conduct a thorough review of our cost structure and pricing strategy, optimize resource utilization, and consider adjusting our prices to better reflect the value of our offerings and the realities of the market. In the following videos, we will learn about the second category called Sales Activity Metrics.