Unit Economics - CAC and LTV

A business can grow fast and still lose money on every customer it wins. Unit economics helps us see this early, by looking at the money made and spent on one unit, such as one customer. Two numbers are at the centre: customer acquisition cost, or CAC, and customer lifetime value, or LTV. Comparing them shows whether growth creates value or burns cash.

1. What Unit Economics Means

Unit economics looks at the revenue and costs of a single unit instead of the whole company. For a shop, the unit may be one sale, and for a subscription business, it is usually one customer. We start with the gross profit of each unit: the price minus the direct cost of serving it. If one unit does not make money, selling more units will not fix the problem.

Example: A coffee cart sells each cup for three dollars, and the coffee, milk and cup cost one dollar. Its unit economics are clear: each cup brings two dollars of gross profit.

At work: Rawan, the marketing manager of a language-learning app, looks at the unit economics of one subscriber. Each subscriber pays ten dollars a month, the cost of serving them is two dollars, so each one brings eight dollars of gross profit a month.

2. Customer Acquisition Cost

Customer acquisition cost is what it costs, on average, to win one new customer. We add up all sales and marketing spending in a period, such as ads, sales salaries, tools and commissions. Then we divide this total by the number of new customers won in the same period. Leaving out some costs makes CAC look better than it really is.

Example: A home baker spends three hundred dollars on flyers and online ads and wins thirty new customers. Her customer acquisition cost is ten dollars per customer.

At work: Rawan's team spends twenty thousand dollars in one month on ads and campaign staff and wins five hundred new subscribers. Their customer acquisition cost is forty dollars per subscriber.

3. Customer Lifetime Value

Customer lifetime value is the gross profit that one customer brings during the whole relationship with the business. A simple way to estimate it is to multiply the monthly gross profit per

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customer by the average number of months that customers stay. It is safer to use gross profit than revenue, because revenue ignores the cost of serving the customer. When more customers leave early, lifetime value falls.

Example: A barber earns fifteen dollars of gross profit each month from a regular customer, who stays for about three years. The customer lifetime value is fifteen times thirty-six months, which is five hundred and forty dollars.

At work: Rawan finds that subscribers stay for twenty months on average. Their customer lifetime value is eight dollars times twenty, which is one hundred and sixty dollars.

4. LTV to CAC and Payback

The LTV to CAC ratio compares the value of a customer with the cost of winning them. An often used rule of thumb for subscription businesses is an LTV at least three times the CAC, but the right level depends on the industry and on how reliable the estimates are. The payback period shows how many months of gross profit are needed to earn back the CAC. A shorter payback means that less cash is tied up in growth.

Example: The barber spent thirty dollars on ads to win the regular customer. The LTV to CAC ratio is eighteen, and the payback period is only two months.

At work: Rawan's LTV to CAC ratio is four, and the payback period is five months. A new ad channel shows a CAC of one hundred dollars, a ratio below two and a payback of more than a year, so she moves the budget to better channels.

Conclusion

In summary, unit economics looks at the gross profit of one unit, the cost of winning a customer, and the value of that customer over time. Comparing LTV with CAC, and checking the payback period, shows whether growth is healthy. These numbers are estimates, so they need regular updates as prices, costs and customer behaviour change. Growth is good news only when each new customer is worth more than the cost of winning them.

Sources

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