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<https://tomtunguz.com/why-margin-matters-2020/>

## Why Margin Matters Now in Startupland

Over the last decade, growth has been the winning card for startups to play. The faster the business grew, the higher its valuation. Margins didn't matter much. Neither gross margin, nor net income margin weighed heavily on a company's valuation unless they deviated grossly from norms. Today, runway ranks as the first consideration in evaluating a company's strategy. Suddenly, margins matter.

Richer margins lengthen runway. Let's illustrate the point with a hypothetical startup at \$1M in monthly revenue. Assume the company grows 5% per month. The company generates a gross profit of 60%. The gross profit is the revenue minus the COGs (cost of goods sold).

For most software companies, COGs encompasses cloud hosting costs and some fraction of customer success and professional services salaries. The company burns \$1.9M per month in operating expense. Operating expense, or OpEx, includes the salaries the remaining employees plus marketing and selling costs, travel, food, real estate, and other expenses.

Month	1	2	3	4	5	6	7	8	9	10	11	12	Year
Revenue	1.0	1.1	1.1	1.2	1.2	1.3	1.3	1.4	1.5	1.6	1.6	1.7	15.9
Gross Profit	0.6	0.6	0.7	0.7	0.7	0.8	0.8	0.8	0.9	0.9	1.0	1.0	9.6
Opex	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9	22.2
Net Income	-1.3	-1.2	-1.2	-1.2	-1.1	-1.1	-1.0	-1.0	-1.0	-0.9	-0.9	-0.8	-12.6

The profit and loss statement of the company shows revenue increasing from \$1M in monthly revenue to \$1.7M. The startup produces \$15.9M in revenue, spends \$22M in OpEx, and generates a loss of \$12.6M for the year.

60% gross margin leaves room for improvement. What if the company could improve it? How many more months of burn could the company yield with this alchemy? Note: I'm assuming net income and cash burn are the same here for simplicity.

Gross Margin	Net Income	Incremental Months of Burn
60%	-12.6	-
65%	-11.9	1.0
70%	-11.1	2.0
75%	-10.3	3.0
80%	-9.5	4.0
85%	-8.7	5.0

Here's the sensitivity table. Varying the gross margin yields net income for each scenario. Each five percentage points of gross margin squeeze one incremental month of burn from the spreadsheet. In this case, gross margin improvements lengthen runway meaningfully.

For startups, there tend to be two significant drivers of gross margin: cloud computing costs and professional services. Reining in the costs for one or both of these may have a material impact on a startup's runway.

In addition, contribution margin is another important figure to analyze. The contribution margin is the cost to acquire a marginal customer, so improvements to the contribution margin reduce the sales and marketing component of the OpEx line. It's harder for companies to improve the contribution margin of customer acquisition as readily as reducing the COGs, but still worth the effort to examine the impact.

If your startup has less than 24 months' runway, you may want to explore the impact of improving gross margin by 5-10%. You may find an extra few months of runway hidden withinin the hinges of your engineers' Aeron chairs.