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How to Calculate an ROI on your ERP Purchase

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A new ERP purchase is a sizeable expense for any organization. That being said, is the cost really worth it? In this article, we will show you how to calculate an estimated ROI on your next ERP purchase. While there are a number of ways to calculate ROI, we are going to focus on calculating ROI at the financial statement level since this is typically a source of data that is readily available and trusted more often than operational data points.

To calculate the ROI a new ERP system can provide your organization we recommend executing the following methodology:

Step 1 – Interview the key business process owners with an objective of identifying the future strategies,existing intiatives and challenges that are hindering growth and enterprise performance.

Step 2 – Quantify and prioritize the opportunities

In order to quantify the opportunities, we recommend focusing on the below listed key metrics. All the listed metrics are calculated from financial statements – no operational data points are needed. Additionally, please note that the listed sample optimization strategies are enabled by NetSuite but might not be executable on all ERP's. Be sure to check out the features and functionalities of the ERP you are evaluating to ensure it can support your optimization strategies.

Key Metric	Sample Optimization Strategies Enabled by NetSuite	Calculation
Income Statement:		**Ex:** Revenue $50M COGS $25M (50%) SG&A $10M (20%) EBITDA $15M (30%)[1]
Annual Revenue Growth	• Improved sales producitivty and capacity • Faster order processing • Better data driven decision making through enhanced reporting • Enahnced customer service through integrated CRM	**Ex:** 1% revenue growth through new ERP on $50M revenue base = $500k in recurring annual revenue optimization.
COGS as % of Revenue	• Reduced variation in labor performance • Better utilization of existing labor and non-labor resources • Increased production efficiency • Better insight into COGS spend	**Ex:** 1% reduction in COGS as % of revenue on $25M COGS base = $250k increase in annual recurring EBITDA or 0.5% optimization to EBITDA.
SG&A as % of Revenue	• Staff productivity optimizations – accounting, HR, IT • Reduced IT costs	**Ex:** 3% reduction in SG&A as % of revenue on $10M SG&A base = $300k increase in annual recurring EBTIDA or 0.6% optimization to EBITDA.
Working Capital:		**Ex:** AR Balance, $10M / DSO 35 days = $285k/day AP Balance, $10M / DPO 25 days = $400k/day Inv. Balance, $15M / DIO 50 days = $300k/day
Days Sales Outstanding (DSO) (Average AR Balance x 365) / Revenue	• Faster time to send invoices • Automated collections processes • Customer portals	**Ex:** 3 days reduction in DSO $285k x 3 = $855k increase in cash (one-time)

[1]Assumes no interest, taxes, depreciation and amortization for simplification purposes.

Days Payable Oustandting (DPO) (Average AP Balance x 365) / COGS	• Automate payback to vendors at last day of terms • Manage purchase requests and vendors centrally • Vendor portals	**Ex:** 3 days increase in DPO $400k x 3 = $1.2M increase in cash (one-time)
Days Inventory Outstanding (DIO) (Average Inventory Balance x 365) / COGS	• Optimized supply chain • Enhanced demand planning and just-in-time inventory • Stronger inventory controls	**Ex:** 3 day reduction in DIO $300k x 3 = $900k increase in cash (one-time)

Please note that is unrealistic to assume you will have optimization opportunities in all the key metrics listed above.

Additionallly, the following are ROI's our clients see from the purchase of a new ERP:

- Staff productivity will increase resulting in an opportunity to right size staffing and/or re-purpose existing employees for other value-add activities
- Through increased EBITDA and cash balances, our clients see higher capital capacities[2] for organic and innorganic growth oportunities
- For companies looking for an exit, multiply the EBITDA optimization by your industries average trading multiple and add the increase in cash to your selling price to see how your exit value has increased signifantly.
- Enahnced internal controls and coorespondingly reduced audit fees

To conclude, once you have calculated the total aggregate value of optimization opportunities, divide that number by the cost of your ERP software to calculate your ROI, as depicted below in the example:

	Software	Implementation	Totals	
Year-1	$ 100,000	$ 100,000	$ 200,000	
Year-2	$ 100,000	$ -	$ 100,000	
Year-3	$ 100,000	$ -	$ 100,000	
3-year Totals	$ 300,000	$ 100,000	$ 400,000	A

NetSuite Improvement Opportunities	**Increase to Cash**	
3-day DPO extenstion (one-time)	$ 1,200,000	
3-day DSO reduction (one-time)	$ 855,000	
3-day DIO reduction (one-time)	$ 900,000	
1% Revenue Growth (annual recurring)	$ 1,500,000	
1% COGS improvement (annual recurring)	$ 750,000	
3% SG&A improvement (annual recurring)	$ 900,000	
Potential increase to cash over 3-years	$ 6,105,000	B
	=A/B	
Return on Investment (over 3-years)	15.3x	

[2]Capital capacity is defined as debt capacity (dollar amount of additional debt an organization can reasonably assume) plus cash.

[3]In order to realize full optimization opportunities additional consulting and change management costs may be incurred by your organization.