Exploring the value of SaaS businesses

SPOT ON | ENTERPRISE SAAS | NOVEMBER 2022

"As the SaaS business model matures, it becomes harder to create a company that stands out from the crowd and captures high valuations. However, there are factors that can help give SaaS businesses a competitive advantage such as mastering relevant metrics and effective scaling management."

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Sector overview

Great SaaS (Software as a Service) companies continue to thrive and obtain high valuations. However, there appears to be a widening gap between what's deemed as 'good' and and what's 'great', which hasn't been a defining feature in the market before. While large funding rounds and headline-making M&A transactions aren't going to disappear completely, thanks to ongoing market demand and rationale drivers, they are likely to become rarer than during the boom times of particularly high valuations. Time will tell how valuations adjust among public companies and the expectations of privately owned companies adapt in the coming months.

The current view is that pre-COVID-19 levels are likely to return.

At the moment, recessionary headwinds and market uncertainty are causing valuations to actually be lower than pre-COVID-19 levels — this is indicative of an overcorrection in the market, so we should soon see some uptick in valuation levels but without a return to the exuberance of 2021. It's also important to note that metrics and those drivers that have an impact on valuations are now far more important than in the past. They should not simply be an afterthought that is only considered during an exit process — they should be utilized and woven into the management and optimization of a SaaS business from its inception, to guide and measure the building of an effective SaaS business model that can grow value for its owners and lay the foundations for future value creation.

WHAT IS SAAS?

While not all SaaS businesses are technically subscription businesses, many that attract the interest of investors and buyers do follow this model or exhibit the recurring revenue, growth and efficiencies of good-to-great subscription businesses. As a business model, SaaS is similar to that of subscription media businesses (i.e. newspaper, channel or digital media subscription) or mobile phone subscription, for example in the way that their development is evaluated and tracked (using indicators such as number of subscribers, average revenue per subscriber, churn, etc.). The difference between the business models is in the costs and investments needed to run them. The largest expenses of SaaS companies are typically related to the development of their software, and to marketing and sales (development costs can be capitalized in many cases, hence they are part of SaaS company CapEx). While a company's usual operational expenses are determined by the size of its operations, software development remains an early and critical development cost, just as media companies need to acquire or produce in-house the content to be distributed to subscribers, and telecommunication operators have to invest vast amounts of capital into their mobile phone network before any subscriptions can be sold.

It should be noted that SaaS businesses and digital media businesses are increasingly able to leverage cloud platform services like Amazon AWS and Microsoft Azure, as well as the plethora of open source software libraries, to reduce software development costs and effort. Some caution does need to be exercised in this area, because although it can speed up software development and time to market, it can also reduce the amount of original IP in the software and pose some additional risks to consider. These cloud platforms enable SaaS startups to both reduce how much they need to spend on capital infrastructure and better optimize their operational efficiency. They can then either take advantage of this to minimize CapEx and operating costs, or redeploy it for hiring exceptional engineering and other talent who can develop a product better and faster to outpace competitors in getting into the market. They can also hire equally exceptional growth development marketing talent as another way to overtake competitors in the critical early market entry and expansion phase of their development, while building value and tracking performance according to the critical metrics that so matter to investors and acquirors.

For subscription-based businesses to be successful, they must forge client relationships that are long-term and provide value to the company.

For instance, some clients may subscribe to a product or service for decades, so the acquisition cost of these clients will be offset many times over and mean that their lifetime income is very profitable. This has a dramatic effect on valuations for such companies, especially SaaS companies that have mastered effective scaling economics that promise highly profitable fast-growing income and future cash flows from their business and software assets. Software companies focused on a certain niche and that have developed their products over many years often have an advantage over competitors that is not easily lost. The right niche combined with a large addressable market opportunity can add a significant premium to valuations, for example, in MarTech and HealthTech. This, together with a business model where the clients are subscribers, means that valuation multiples can be notably higher than in businesses where each new customer transaction is completed separately time after time. Well-run SaaS companies often have a very high gross margin — software that clients subscribe to increasingly runs on a cloud platform, so very few additional costs are incurred as the number of users increase.

With good cloud and scaling management, the direct costs related to running the platform can be minor, and well-managed SaaS companies can often achieve a gross margin of 80–90% or more.

All digital SaaS business models enable better monitoring of and analytics regarding client activity compared to media or telecommunications, because SaaS companies can track user activity with their software. Consequently, they can identify usage patterns to support the business with future sales and up-sells, optimize operations, and reduce user defections by identifying and addressing user experience issues early on and thereby avoid lost subscription revenues. Furthermore, there are many more ways to develop strategies to manage churn within SaaS compared to other subscription businesses, for example building customer value via 'how to' purpose-driven communication.

MAKING SENSE OF SAAS METRICS AND TERMINOLOGY

Metrics overview

Effective SaaS companies utilize metrics that assess the most important aspects of their business related to the company's lifecycle. Early phase and fast-growing companies, for example, often use growth and profitability with the monthly level burn rate as their starting point, but may also measure the number of clients, client lifetime value, net retention rate and churn. In addition to financial and client-based metrics, user engagement and activity on it are constantly measured to find out whether there are clients who are underutilizing the platform (in these cases, good client management, which is often referred to as customer success, can avoid possible early contract terminations).

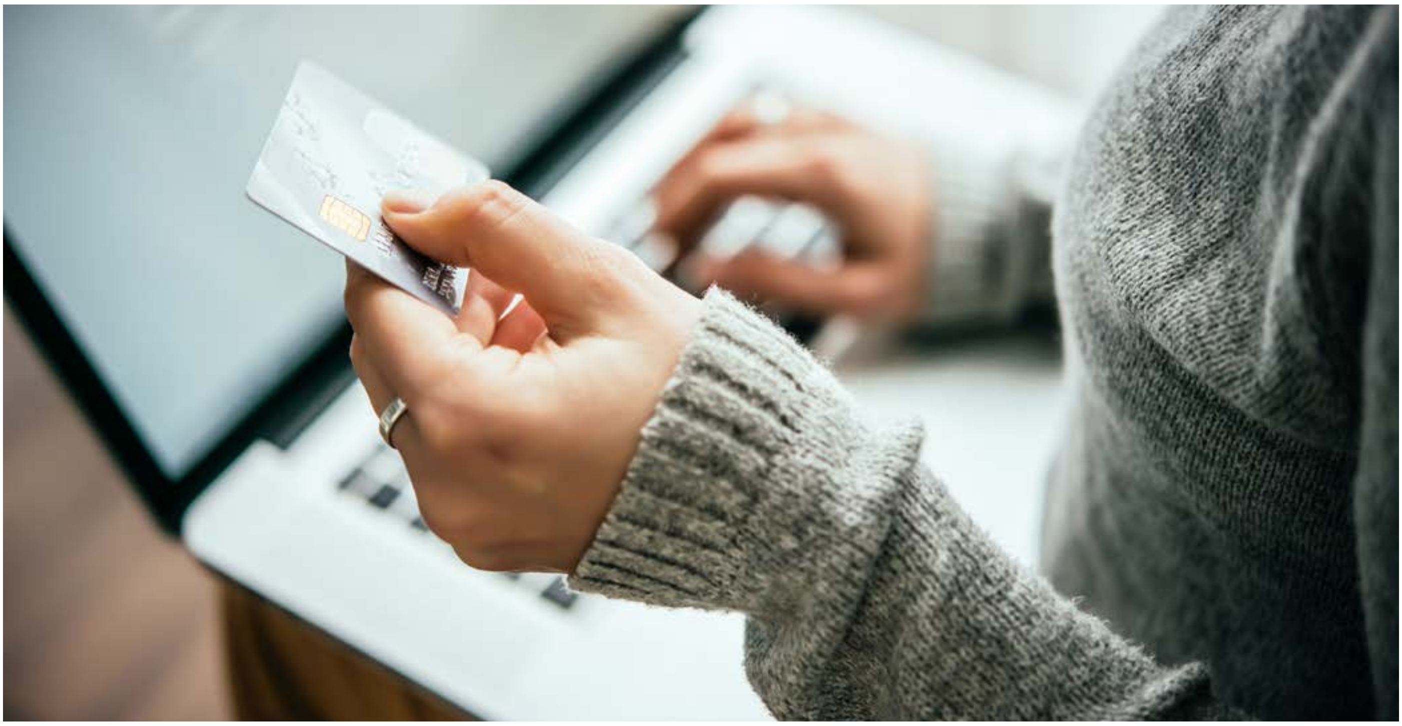
Rule of 40%

The "Rule of 40%" is a metric used to assess the health of a SaaS company. The rule is simple: growth rate + profitability (typically EBITDA as a %) should be 40% or more for your company to be considered healthy. As the figure is the sum of two metrics, it allows for changes in a company's situation and can be calculated in many ways — for instance 20% profit and 20% growth would be 40% in total, the same as if your company grows by 50%, but has negative EBITDA of 10%. Companies that exceed the rule of 40% are typically valued notably higher than companies that do not exceed the threshold.

SaaS businesses can also be compared to rental businesses, in that software assets are often being valued according to the projected cash flows that the IP and software asset can produce going forward.

Although the rule of 40% is not an all-encompassing metric that investors and buyers use when analyzing potential targets, it can be an important starting point. More significant for buyers are product market fit and strategic fit, while if a product add-on is being considered then forecast cash flows and market access for the seller can also be key. Investors tend to look for growth and pace of growth, and the total addressable market (TAM) accessible to the seller. It is also increasingly important to them to have business data that can simplify the financing process.

SaaS businesses should start collecting relevant business and user data as early as possible after starting operations.



SAAS METRICS AND TERMINOLOGY (cont.)

MRR/ARR/TCV development

The most important metrics that SaaS companies follow are concerned with the monthly and annual revenue generated by clients (monthly recurring revenue or MRR, and annual recurring revenue or ARR). Closely related to these metrics is total contract value (TCV). But what does each one cover and how are they calculated?

MRR — total number of payments that the company receives each month based on recurring contracts made with clients. The MRR metric is usually updated on a monthly basis.

ARR — total value of contracts that are longer than one year (i.e. ARR metrics should not be used for contracts that last less than one year).

TCV — total value of the customer base at any given moment. This metric is calculated using the following formula: contract length x monthly recurring revenue (+ one-time fees).

GM, LTV/CAC, NRR, Churn

GM — SaaS companies track the development of gross margin (GM) over time with different cost allocations. The higher GM a product has, the more a company can invest in marketing and sales. A product with a GM of 50% needs almost twice the sales of a product with a 90% GM to generate similar amounts of GM.

LTV/CAC — Customer lifetime value (LTV) compared to the customer acquisition cost (CAC) metric describes how good the product market fit is relative to the effectiveness of customer acquisition operations. Changes in the go-to-market (GTM) model during the first years of a business compared to its current situation can have a significant impact on the CAC metric. In other words, when evaluating the company lifecycle, changes in the GTM model and how they affect CAC over time need to be understood.

A new GTM model has emerged in recent years know as product-led growth (PLG). PLG has been particularly effective in keeping CAC down for companies addressing the SMB market or those going after departmental rather than enterprise sales at larger businesses. In simple terms, PLG brings direct-to-consumer (DTC) digital marketing into the orbit of B2B sales and marketing to generate demand and sales conversions — this has helped rapid growth at SaaS businesses like Canva, Figma and Sling, a desktop and mobile app business recently bought by Toast that helps restaurants, coffee shops and the like better manage the shifts of their staff.

NRR (net retention of customers or net dollar retention) — Net retention rate (NRR) describes the recurring revenue received from existing clients over a specific period (typically a year). Net dollar retention considers the ups and downs of sales related to the clients in question. The point is that even if the number of clients remains flat, there may still be growth in revenue as those existing clients subscribe to new, better services (it also works the other way around, meaning that clients may downgrade their product, which leads product leading to less revenue).

Churn (client churn, dollar churn) — Churn rate measures the number of clients terminating their subscriptions during a given period (annual churn is a common measurement). Churn can also be measured based on client contract value level (dollar churn). Both metrics are important, and are used according to a company's particular situation. For example, a company with one product and one price would measure client churn, while another that has more product tiers may also monitor whether client contract value is increasing as they upgrade their products. Dollar churn is an important part of net retention rate metrics.

Other key factors in valuation analysis

As happens in other sectors, SaaS companies are evaluated on the maturity of the market they are in, their specific business position, the size of their addressable market, and the competitive landscape including entry barriers and the strength of market incumbents, if they exist. Market maturity affects the growth profile of the company — the more mature a market is, the less it is usually expected to grow and the more stable the competitive landscape. Companies competing in mature markets can offer steady cash flows and less risk than those in growing and evolving markets, but in contrast, the latter offer better growth opportunities (and opportunities to grab a commanding portion of the market).

Trending sectors and related interest and/or competition always affect valuations for limited time periods, which may last only a few months. There have been numerous examples in the market where high-demand assets attracted multiple bidding parties and drove valuations to record highs. Targeted solutions and competition related to sector maturity may also be considered in terms of product stickiness and barriers to changing a product. A fast-evolving market sector can be reflected in net retention trends over time, which will change as the sector matures and market shares are stabilized.

Positive cash flows or a clear path to reaching them have become almost mandatory in achieving high valuations for SaaS companies. In that sense, close attention should be paid to operational efficiency, which includes cloud operation cost management that still meets scalable design and engineering from the start, as well as arranging operations to deal with superior customer success. Some companies can utilize PLG to drive scaling while keeping customer acquisition costs low, although this approach won't work in every situation and the tactics used will need tailoring.

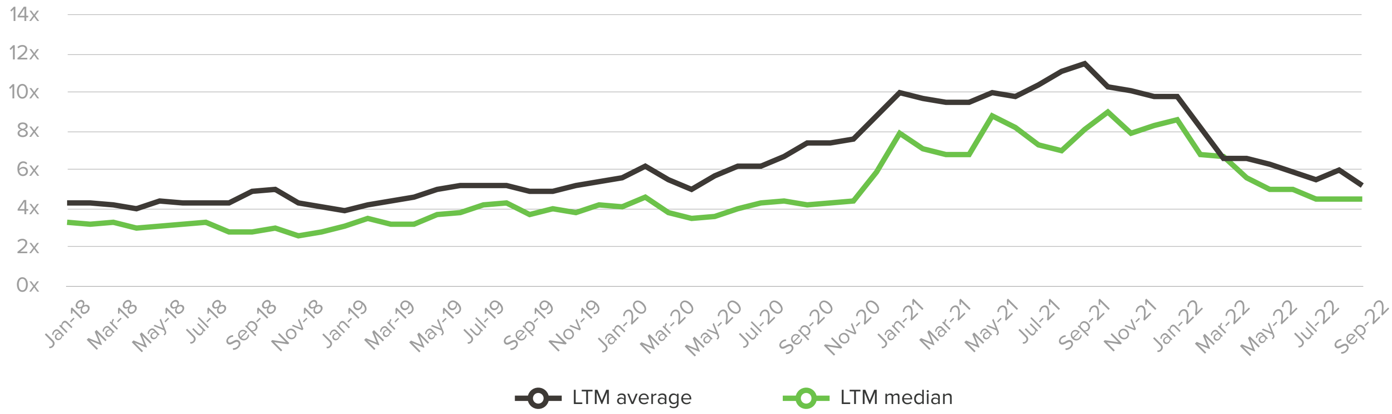
Valuation trends

OVERVIEW OF CURRENT MARKET MULTIPLES

Even though listed SaaS companies are a heterogenous group, the overall business model features a certain valuation logic and this can be seen in the sector's recent development in terms of multiples. The business model favors long-term, predictable cash flows, which in valuation analysis react heavily to rising interest rates and risk premiums. Of course, the selected multiples vary significantly at a company level as the market currently uses Enterprise value (EV) to Sales for publicly listed SaaS companies in overall, and EV to EBITDA as a supportive guidance for the cash positive companies. MRR, ARR and TCV multiples are also widely used in analysis, but these are not easily accessible for many SaaS companies so comparisons are difficult.

PUBLIC SAAS COMPANIES' VALUATIONS RETURN TO PRE-COVID-19 LEVELS

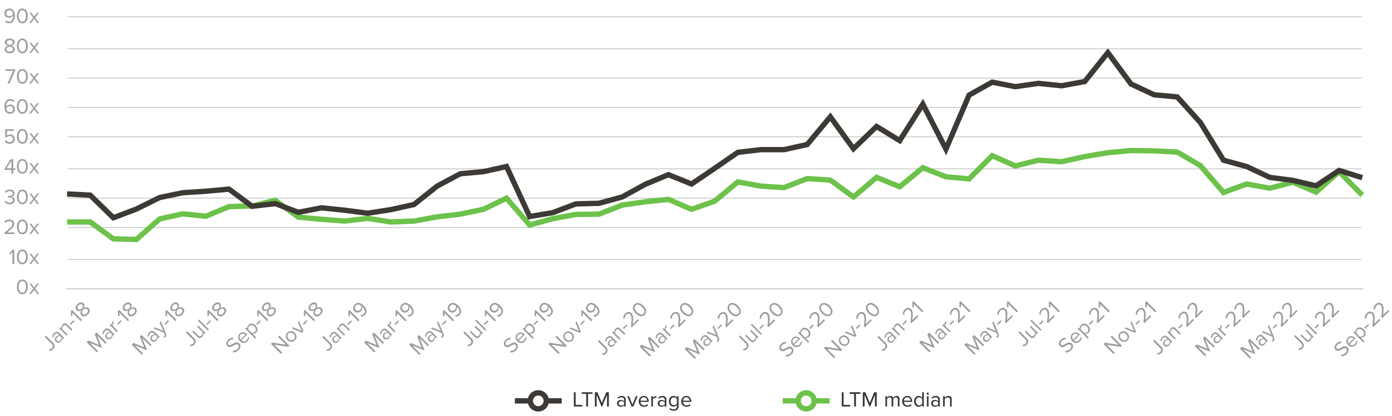
SaaS EV/Sales



Source: S&P Capital IQ

Median EV/Sales multiples have decreased to levels that were common pre-COVID-19, with investors becoming more conscious about the profitability and cash flows of their investments.

SaaS EV/EBITDA



Source: S&P Capital IQ

The EV/EBITDA multiple average has also decreased significantly as the valuations of companies with high growth but limited profitability have fallen notably, as a result of investors favoring positive cash flow over the pure growth focused on by negative cash-generating companies.

Looking forward

WHAT NEXT?

We are facing an interesting and fast-changing M&A market, which particularly affects SaaS companies because their business model is becoming mature after a couple of decades of parallel valuation turbulence.

It has become clear that to achieve a high valuation, a SaaS company must stand out from the crowd.

This can be done through exceptional business performance and growth metrics, and/or exceptionally scarce but relevant proprietary IP, or in some other way, such as the quality and performance of the management or engineering team.

SaaS was once a disrupter in a complacent software industry that had not recognized the significance of the arrival of the internet and then the world wide web for its business model.

As SaaS matures it hasn't itself been immune to disruption, creating a division between first-generation SaaS businesses that exhibit value in their size and growth, and emerging second-generation SaaS businesses that better utilize and optimize their operations for cloud platforms, embrace and often lead with mobile technology, and adopt radically different sales and marketing strategies such as customer success management and PLG to accelerate growth without geographic boundaries. In some cases they can also master how to scale sales and marketing while maintaining lower customer acquisitions costs as they do so.

When considering the SaaS sector today, there are two important points to keep in mind. The first is that in some regulated industries, the SaaS business model may not be appropriate, particularly in terms of SaaS utilizing proprietary or public cloud platforms, although on-premises SaaS may be acceptable. The second is that easy and affordable access to pay-as-you-go public cloud platforms is fueling an explosion of SaaS businesses and software in the market.

SaaS businesses are no longer a scarcity, and as such, simply being a SaaS business is not enough to command a premium valuation. To drive such top-level valuations, a SaaS business or software must either be unique in some way, so it’s scarce while still being relevant to the needs of an existing or emerging market, or it must be a super-performer that is growing faster than and outperforming competitors according to the metrics that matter to investors and buyers. What’s more, recessionary headwinds mean it’s necessary to also expertly optimize for both revenue growth and profitability, unlike in the past when SaaS business leaders only had to optimize their businesses for rapid growth.

We at Oaklins are happy to advise you on how to navigate value creation and capture within the ever-evolving SaaS sector.

Our track record

ACEPTA has been acquired by SOVOS — M&A SELL-SIDE — TMT	Confirma Software has acquired Quick systems — M&A BUY-SIDE — Private Equity/TMT	critical mention has been acquired by Onclusive, a portfolio company of STG — M&A SELL-SIDE — Private Equity/TMT	EPICENTER EXPERIENCE has been acquired by STAGWELL — M&A SELL-SIDE — TMT
helixa has been acquired by telmar, a portfolio company of Boathouse — M&A SELL-SIDE — TMT	LeadDesk has acquired LOXY SOFT — M&A BUY-SIDE — TMT	Mail Manager has been acquired by Ideagen — M&A SELL-SIDE — TMT	OBI4WAN has been acquired by spotlergroup — M&A SELL-SIDE — Private Equity/TMT
Oktey has been acquired by Vincent Saint-Martin and ciclad — M&A SELL-SIDE — Private Equity/TMT	PSG has made a strategic growth investment in RODEO — M&A BUY-SIDE — Private Equity/TMT	Sentenial has been acquired by EML — M&A SELL-SIDE — Financial Services/TMT	Crowberry has sold SLING to toast — M&A SELL-SIDE — TMT
VITEC vertical software has acquired ABS Laundry Business Solutions — M&A BUY-SIDE — TMT	TICTRAC has been acquired by Dialogue — M&A SELL-SIDE — Private Equity/TMT	The Floow has been acquired by otonomo — M&A SELL-SIDE — TMT	vabi has been acquired by VITEC vertical software — M&A SELL-SIDE — TMT

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- Corporate finance services

Enterprise SaaS is one of our focus areas. Combining comprehensive sector knowledge with global execution has led Oaklins to become one of the most experienced M&A advisors in the enterprise SaaS sector, with a large network of relevant market players worldwide. This results in the best possible merger, acquisition and divestment opportunities for enterprise SaaS companies.

If mergers, acquisitions, or divestitures of businesses or business units are part of your strategy, we would welcome the opportunity to exchange ideas with you.

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Joni leads Oaklins' enterprise SaaS team and is a partner at Oaklins Finland. As part of his sector focus, he continuously follows market developments and maintains regular contact with the major players in this sector. Consequently, he has a deep understanding of the market dynamics and value drivers in enterprise SaaS.

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John is a managing director at Oaklins DeSilva+Phillips in New York. Coming to investment banking after a career in the technology and management consulting sectors, John has more than 10 years of investment banking experience advising sell-side and buy-side middle-market clients on M&A transactions. Notable SaaS-related transactions include the sale of Admeta to WideOrbit and the sale of Helixa to Telmar.

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