WHITE PAPER - 2019 v01

WHAT'S YOUR SAAS COMPANY WORTH?

This white paper is written for entrepreneurs, angel investors, and the management teams of SaaS businesses. The intent of the paper is to describe the approach used by most professional investors and strategic buyers to value a SaaS company. By better understanding the concepts and mechanics of valuing a SaaS business, management will be better able to articulate and maximize the value of their company, and also develop a more accurate estimate of the likely offers in a sale process or equity raise, resulting in a narrower bid-ask starting spread and higher likelihood of a successful outcome. The framework described in this paper is designed to be adaptable to the market environment well into the future.

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INTRODUCTION

Like all businesses, a SaaS company is worth what a buyer and seller agree upon, and is based on an estimate of the current value of its future cash flows. That simple sentence includes two essential concepts:

1) The marketplace determines SaaS company valuations during a process of negotiation between two parties.

2) A set of assumptions about the size, timing, and predictability of the future cash flows generated by the business are the basis for negotiation.

In the following pages, we will try to add insight into both the general valuation parameters of the marketplace and also the fundamental assumptions about future cash flows of an individual SaaS business.

The paper consists of seven sections:

1. The Basic Valuation Formula
2. Public Company Valuations
3. Translating Public Valuations to Private Companies
4. Company-Specific Value Drivers
5. The Balance Sheet
6. Other Valuation Drivers
7. Sample Valuations From Our Portfolio

THE BASIC VALUATION FORMULA

For private SaaS businesses, the net present value of future cash flows can be reduced to a shorthand formula based on a multiple of the company's annualized revenue.

Annualized Revenue x Multiple = Company Valuation

Anything that affects the projected size, timing, and predictability of future cash flows impacts the revenue multiple. Those factors include company-specific drivers such as growth rate, gross margins, retention, etc. and external or macro factors such as economic growth expectations, fear of war, tax policy, etc.

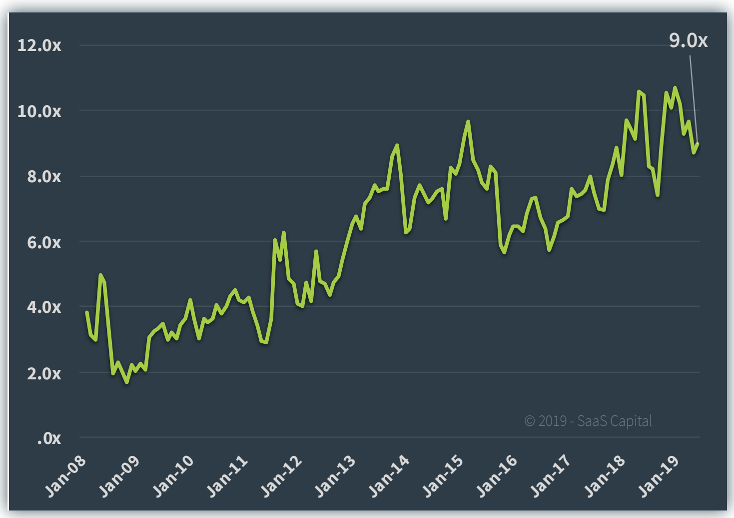
The company-specific factors drive the projected cash flows, while public company valuation multiples reflect the implicit macroeconomic discount rate. Said differently, the current public market valuation multiples incorporate all known macroeconomic uncertainty, and the company-specific factors adjust it from there. Sometimes the baseline valuation multiple is 9.0 times revenue; sometimes it is 4.0 times; it just depends on when you are selling. *Figure 1* depicts the median public SaaS valuation multiples since 2008. We will further explore the public market baseline multiple below in the "Using Public Company Valuations" section.

So why do SaaS companies trade on revenue, while all other businesses trade on EBITDA or net income, both of which are closer approximations of cash flow?

Net income takes a long time to materialize for growing SaaS businesses, even if underlying unit economics are robust. Sales and marketing expenses are recognized upfront, while revenue persists over many years. This "lag" makes new customers unprofitable in the short term, even though they clearly will be profitable over their lifetime. If a SaaS business is growing quickly, there are a lot of new (temporarily unprofitable) customers making net income negative. This is true even though the business could stop growing and it would immediately throw off cash. For this reason, revenue is a better indicator of long-term cash flow for a SaaS business than net income or EBITDA. This approach to valuation will likely change as the sector matures, but even for the largest SaaS businesses today, there is little relationship between overall profitability and valuation.

Figure 1

Median Public SaaS Company Valuation Multiple



Source: The SaaS Capital Index

How should revenue be measured?

Before moving on to the different drivers of the valuation multiple, let's discuss the first part of the equation – revenue. When a buyer or investor evaluates a business, they will look closely at the different revenue streams, and when possible, value them differently. High gross margin recurring license fees generate more future cash-flow and are more highly valued. One-time services fees like implementation are valued less, with recurring services falling somewhere in the middle. Refer to the Gross Margin & Revenue Mix section below for more detail.

The generally available data on public and private valuation multiples include companies with varying percentages of services revenue, which is not necessarily disclosed separately. We do know, however, from our survey of over 1,000 SaaS businesses, and available public data, that the average mix of license fees to services revenue is 80% to 20%, respectively. So, if your business has a similar 80/20 revenue mix, the revenue multiple developed here applies to your entire revenue stream, not just your license revenue or Annual Recurring Revenue (ARR). However, if your services mix is significantly higher, or you have hardware or other types of revenue, you will need to calculate separate adjustments downward for individual revenue streams.

It's also important to note that when looking at most public company data, valuations are typically reported as a multiple of either last year's revenue, next year's revenue, or the trailing 12 months of revenue. All of these revenue figures add unnecessary noise to determining a precise measure of current revenue, which is the company's annualized run-rate revenue. **The SaaS Capital Index**, referenced throughout this paper, calculates valuation multiples based on run-rate revenue to make a comparison to your business more direct. If you are using another index, it will be important to keep this nuance in mind and adjust accordingly.

"Anything that will impact the size, timing, and predictability of future cash flows will be incorporated into the revenue multiple."

Having outlined the basic approach to valuation, let's now take a more in-depth look at public SaaS company valuations.

PUBLIC COMPANY VALUATIONS

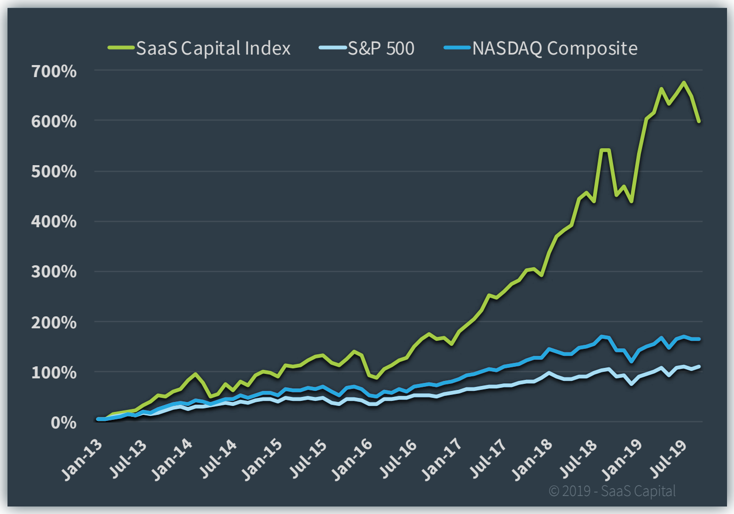
Public market valuations reflect real-time information and have high data integrity because they include many different companies and are based on audited financial statements. Public valuation data is the primary starting point for valuation analysis by both buyers and sellers.

There are several different public SaaS indices available, including one developed by SaaS Capital – aptly called **The SaaS Capital Index**. The companies in our index were selected to represent pure B2B SaaS companies, and specifically excludes companies like LinkedIn (when public), PayPal, Carbonite, and Dropbox. The index also excludes legacy and conglomerate software vendors such as Microsoft and Oracle, who have a mix of perpetual and SaaS revenue.

Because public valuation data changes constantly, any valuation analysis should begin by downloading the most current **SaaS Capital Index** dataset available to download from the SaaS Capital website.

Figure 2

SaaS Capital Index vs. S&P 500 & NASDAQ



Before we discuss the mechanics of using the public valuations, let's pause here to understand a bit about how the public company valuations have behaved over time. *Figure 2* compares the **SaaS Capital Index** to the S&P 500 and NASDAQ composite index since 2013.

First, it's impossible not to notice how SaaS company valuations have outperformed the broader market in the last three and a half years. Broadly speaking, since early 2017, the valuations of SaaS businesses have increased three times more than the broader stock market.

The increase in SaaS valuations over the broader market during this period primarily resulted from SaaS companies growing revenue (their key valuation metric) faster than the rest of the companies grew net income (their key valuation metric). Also contributing, but to a somewhat lesser extent, was the fact the average SaaS company revenue valuation multiple increased more over this period than the price-to-earnings multiple increased for the rest of the market.

The other thing that's easy to see is the SaaS index is bumpier than the other indices indicating its higher volatility. The higher volatility is explained by the fact that the index is comprised of fewer companies, and SaaS is still an emerging space comprised of smaller market capitalization companies with higher stock price volatility.

We are not public market investors, however, there have been two recent, apparent over-corrections in SaaS valuations in early 2016, and late in 2018 when SaaS valuations fell much more aggressively than the broader market. In each case, the underlying companies' performance was relatively consistent and it was mostly the market expectations that changed. In both occurrences, company values rebounded and eventually out-performed the broader market. The upshot of this pattern is that if you are looking to sell your business during a period of "correction" in SaaS values, choosing not to sell and waiting for it to pass has historically been a successful strategy. It would also be fair to note that as of the writing of this report, the median public SaaS revenue multiple of 9.0 is substantially above historical norms. The timing of an equity raise or company sale is difficult to manage, and future public SaaS valuations are difficult to predict, however, an awareness of historical public SaaS valuation trends can provide meaningful guidance for fundraising and sale decisions. Therefore, selling a SaaS business in the macro environment of the fall of 2019, for example, would generally be constructive.

> *"Awareness of historical public SaaS valuation trends can provide meaningful guidance for fundraising and sale decisions."*

Figure 3 shows that the median public B2B SaaS business has $562 million in revenue, is growing at 22.7% year-over-year, has gross margins of 73%, and is worth about 9.0 times run-rate revenue as of October 1, 2019. This baseline now becomes the starting point of our analysis and we will build from here. The great thing about public market data is you can easily find it, and it's updated constantly. The drawback of public valuation data, however, is that it does not represent the realities of the typical private SaaS company, which is much smaller.

Figure 3

SaaS Capital Index: Company Metrics

Revised 10/1/2019	Market Cap ($ Billions)	EV/Run Rate Revenue	Run Rate Revenue ($ Millions)	Growth Rate	Gross Margin
Median	$ 5.13	9.0x	$562	22.7%	73%
Mean	$ 13. 54	10.1x	$1,384	24.6%	73%
Low	$ 0.44	1.8x	$ 167	- 5.5%	45%
High	$134.35	27.9x	$15,988	85.1%	90%

Source: SaaS Capital Index

To value your SaaS business, start by downloading the most current SaaS Capital Index dataset from our website.

TRANSLATING PUBLIC VALUATIONS TO PRIVATE COMPANIES

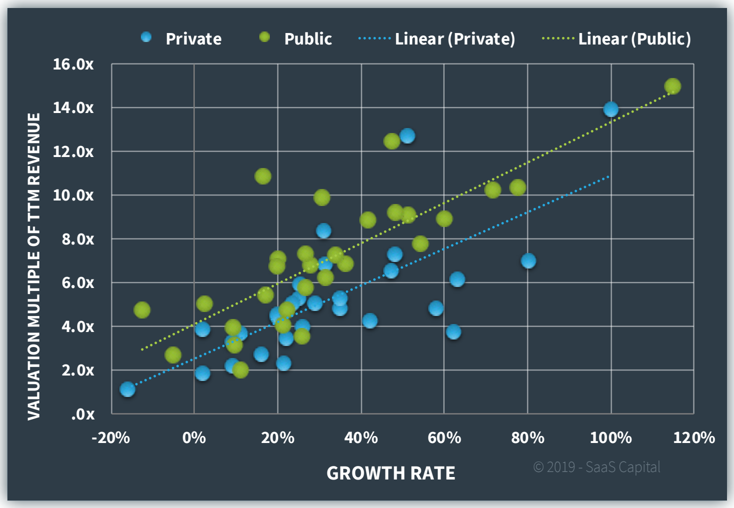
The valuation drivers in private markets are the same as in the public markets, although the private company valuations tend to be lower because the companies are smaller (riskier) and shareholders do not have liquidity. That is, they can't buy or sell their shares in the company whenever they want.

Unfortunately, valuations in private transactions are rarely disclosed and valuation multiples alone, without knowing the growth rate of the underlying businesses, are not particularly useful. Fortunately, SaaS Capital has been directly involved in 30 SaaS companies that have either raised equity or sold their business over the last five years, and we know the growth rates and valuation multiples for all these companies.

Taking the private company valuation multiples from our portfolio and overlaying them on the public company multiples over the same period and across companies with similar growth rates yields the graph shown in *Figure 4*.

Figure 4

Private vs. Public Multiples

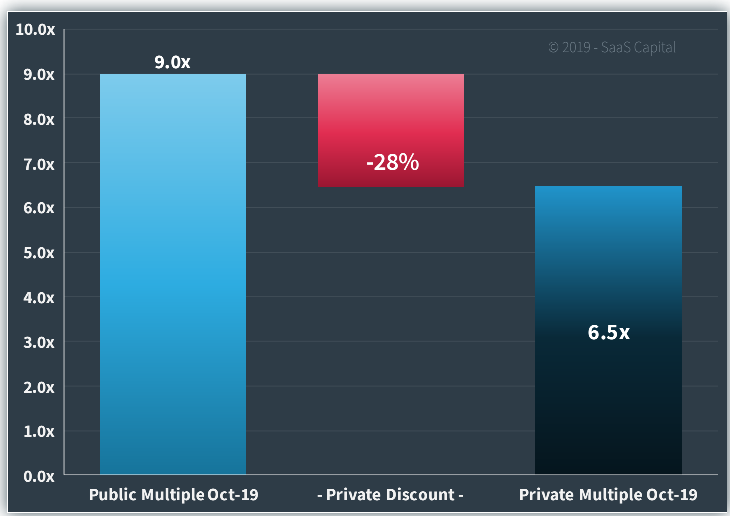


The Valuation Multiple Spread

If you look closely at *Figure 4*, you will notice that the difference between the public and private revenue multiples is about 2.0x across the spectrum of growth rates. Please note, this chart is only intended to demonstrate the discount applied to private versus public companies and should not be used for any current valuation calculations because it relies on data some of which is five years old. The 2.0 times revenue discount represents a 28% discount to the average public valuation multiple over that period. So, mechanically, start your valuation analysis with the most current median public valuation multiple in the **SaaS Capital Index**, and then apply the private company discount of 28%.[1] Therefore, as of our publication date in October 2019, the current baseline private company revenue multiple is 6.5x, depicted in *Figure 5*.

Figure 5

Private Company Discount Factor



1 While SaaS Capital will update the private company discount factor on a regular basis, 28% has shown to be a relatively stable value over time.

COMPANY-SPECIFIC VALUE DRIVERS

Having established both the basic formula of SaaS valuations as a function of revenue and provided a way to calculate a baseline revenue multiple at any point based on public company valuations, we will now explore the company-specific factors that will cause a multiple to be higher or lower.

To maximize company value, individual company characteristics need to be carefully evaluated, isolated, and considered in the overall context of the broader market. Drawing upon our experience selling and financing hundreds of companies and seven years of proprietary survey data from 1,000 private SaaS companies, we have assembled the following list of value drivers every operator should consider as they prepare for an equity raise or sale of their company.

Listed in order of importance, the company-specific drivers of financial valuation are:

1. Growth & Scale of Revenue
2. Market Size
3. Revenue Retention
4. Gross Margin & Revenue Mix
5. Customer Acquisition Efficiency & Unit Economics
6. Profitability

"To maximize company value, individual company characteristics need to be carefully evaluated, isolated, and considered in the overall context of the broader market."

VALUATION DRIVER #1

GROWTH & SCALE OF REVENUE

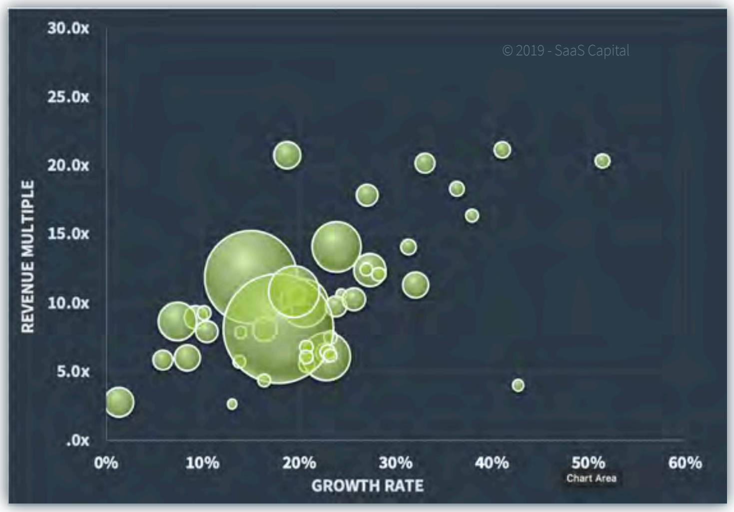
How much revenue is there now? How long will it take to get bigger? How likely is it to happen?

A company's historical growth rate is the single biggest driver of the valuation multiple. It has dwarfed all other factors for a long time. The reason high historical growth is so valuable is that it is predictive of both the timing (sooner), and size (larger), of future profits. And because of the recurring revenue model, high historical growth rates make projected future profits more likely (lower risk).

The relationship between growth and valuation multiples was shown in *Figure 4* and it applies equally to public and private businesses. The correlation between growth and valuation is not perfect, but it is solid and outweighs all other metrics. Faster-growing businesses get higher multiples, while the slower-growing businesses get lower multiples.

Figure 6

Revenue Multiples vs. Growth



Source: The SaaS Capital Index

Growth rate alone, however, does not tell the full story. It is much easier and more common for a $5 million business to grow at 40% than it is for a $500 million revenue business. This relationship is simply due to math (based on the size of the denominator) and the standard growth curve, which slows over time for all businesses. (Refer to *SaaS Capital Research Brief 6, The Daunting Math of Growth*, for more details.)

The size of the bubbles in *Figure 6* indicates the relative size of revenue for each company. You'll see in the chart that for a given growth rate, the larger bubbles (larger companies) generally receive a higher valuation multiple than a smaller company growing at the same rate. Larger companies are less risky, and if they are still growing nicely at scale, by definition, they have a significant addressable market.

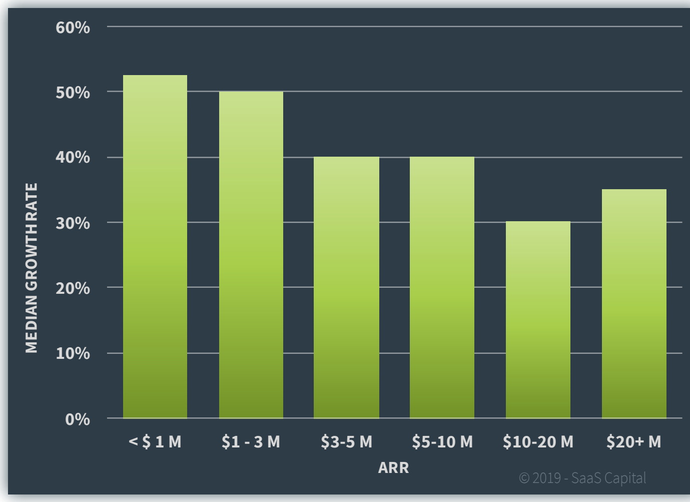
Byron Deeter at Bessemer Ventures likes to tell the story that many early-stage SaaS companies point out to him that they are growing much faster than their public competitors and, therefore, should get a premium valuation. The more relevant comparison, however, is to compare the growth rates of the companies when they were both the same size. Many public SaaS businesses now growing at 30% were growing at 200% when they were $5 million or $10 million in revenue.

The basis for supporting a "growth premium" is to demonstrate that your company is growing faster than its similarly-sized peers. To help you figure that out, we have included *Figure 7*: the median growth rates for SaaS businesses of different sizes based on our 2019 survey of over 1,000 private SaaS companies.

If your business is growing faster than its peers based on the data in *Figure 7*, you should be able to garner a higher multiple. How much higher? You could look to the slope of the line on the public market graph for guidance, keeping in mind, however, that as companies scale, growth rates converge, and each percentage point difference in growth is a much bigger deal and garners a larger premium for bigger companies.

Figure 7

Median Growth Rate by ARR



Source: SaaS Capital Survey 2019

More pragmatically, and building off the SaaS Capital survey data, if your SaaS business generates from ***zero to $3 million*** in ARR, it needs to be growing at least 50% to receive the average private revenue multiple. Growth rates of 60% to 70% would garner multiple premiums of 1.0x to 2.0x, and above 75% could push multiples up by 3.0x to 5.0x if accompanied by a verifiably large addressable market.

For SaaS businesses in the ***$3 to $10 million range***, a growth premium will become relevant above 40% revenue growth. SaaS businesses in this size range that are growing above 50% could easily see premiums of 1.0x to 3.0x revenue. Growth of 60% or more with annual revenues above $20 million puts the business in more rarefied company with growth premiums reaching 6.0x to 10.0x.

For companies with ***more than $10 million*** in ARR, growth above 30% to 50% earns a premium. These larger businesses can achieve outsized premiums of 5.0x to 10.0x if growth rates push north of 50%.

For private companies raising money from VCs, the growth imperative accounts not only for differences in valuation but also in the likelihood of success. Slower growing SaaS businesses are difficult to get funded at any price. These businesses must find a way to demonstrate some source of organic growth that can be leveraged with additional capital. Only then will it be worthwhile to invest the time and energy in external fundraising.

> *"The basis for supporting a 'growth premium' is to demonstrate that your company is growing faster than its similarly-sized peers."*

On the M&A front, the growth imperative is almost as strong. There are exceptions when a corporate buyer is looking for a particular need that can only be filled by a single company; however, typical buying scenarios generally revolve around growth. "I can't even take an acquisition opportunity to my CEO unless they are growing faster than we are," said an SVP in a large SaaS business growing at 29%.

To illustrate each company-specific value driver we have invented "SlowCo," a hypothetical business. SlowCo is a good SaaS company with many positive attributes, but it is growing more slowly than its peers with $5 million in recurring revenue and an annual growth rate of 20%.

As *Figure 8* shows, all valuations start with the most current public market multiple from the SaaS Capital Index, then the private market discount of 2.5x is applied along with company-specific premiums or discounts. In our example, a 1.5x to 2.5x multiple reduction is supported by the data since SlowCo's growth rate is approximately half the rate of its peers.

Figure 8

Growth Impact on Valuation: SlowCo Example

VALUATION DRIVER #2

MARKET SIZE

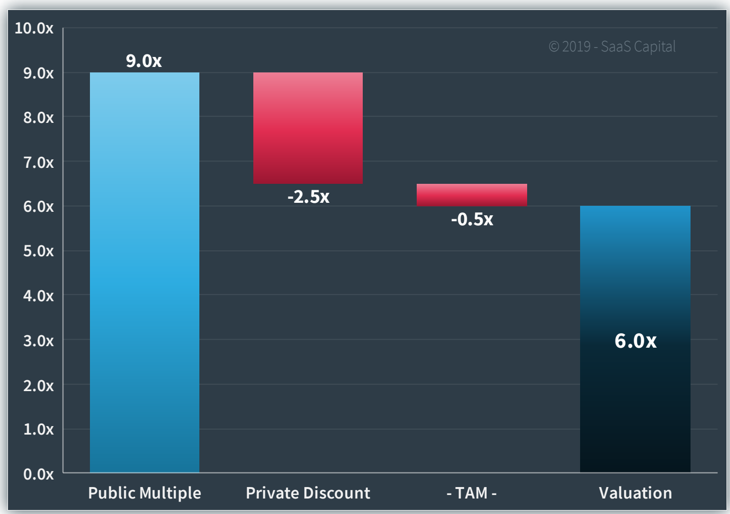
How big can your business be?

Determining an addressable market size is a key valuation battleground. Your business must be able to clearly and credibly articulate how it will generate large profits in the future. Keeping in mind that small businesses in small markets do not ever generate large profits, the size of your addressable market establishes the upper bounds of your future cash flow and therefore, ultimately determines an upper limit to your valuation.

For this reason, VCs and buyers dig deeply into the company's market size, particularly for more mature companies. They want to understand your total addressable market (TAM). In other words, if you sold all your current products to all the potential buyers of those products, how big would your company be? Investors will not pay a $50 million valuation for a SaaS business in a $100 million market. The upside is too limited.

Figure 9

Market Size Impact on Valuation: SlowCo Example



In our experience, managers and owners do not do a good job framing the market-sizing discussion. This omission is unfortunate because operators are in a much better position to build the case for their own business. With a bit of research, a management team can put together a well-organized addressable market presentation that will generally be accepted by the investor.

Little public data is available that connects the size of an addressable market to a revenue multiple because TAM itself is subjective. Generally speaking, TAM enters the valuation equation as a negative factor if the market size is small.

In the specific case of SlowCo, the business is entrenched in a relatively limited vertical market which lowers their valuation multiple for this factor, as *Figure 9* shows. However, their vertical market orientation will have some accretive benefits in other factors, such as retention and customer acquisition costs, which are discussed next.

VALUATION DRIVER #3

REVENUE RETENTION

How reliable is the business you are building?

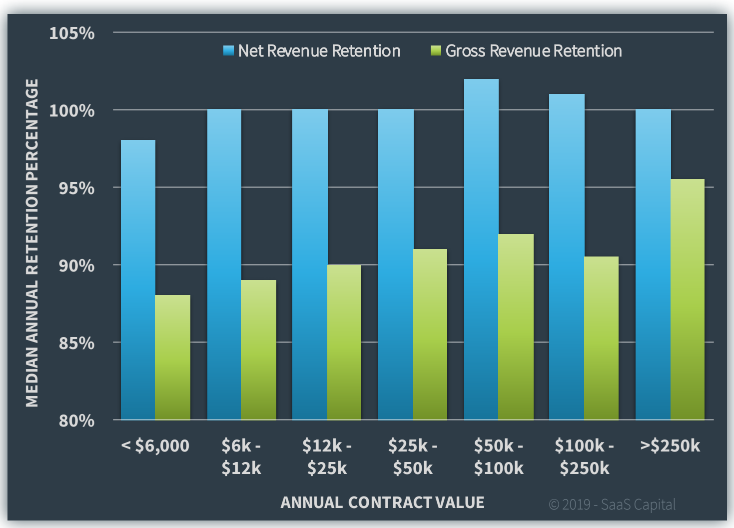
Revenue retention is a significant driver of enterprise value because it touches upon all the key factors that impact the future cash flows of a SaaS business. High retention increases revenue growth rate, improves unit economics, increases profitability and even increases the size of the addressable market. Most importantly, it improves revenue predictability, thereby reducing perceived risk. Lastly, it is also cumulative, so small changes in churn will have a significant impact over time.

SaaS Capital has published numerous articles on SaaS company retention rates over the years and in our white paper *No Churn: Keep Customers and Improve Your SaaS Company Valuation*, we numerically demonstrate how a 1% improvement in net retention will increase a SaaS company's value by 12% over five years. That paper was written a few years ago, and using 2019 valuation multiples, a 1% increase in retention should now create a 15% increase in value over five years.

In the context of the valuation framework, however, it is essential to *isolate* how retention impacts valuation. Better retention improves a company's growth rate and results in higher revenue over time. These two factors, however, are already incorporated into a company's valuation based on its run-rate revenue and growth premiums. Additional value is created, however, when a company's retention rate is above that of its peers because high-retention businesses are less risky and have better unit economics. Buyers and investors will pay a premium for efficient businesses they perceive as predictably losing very few customers.

Figure 10

Retention by Annual Contract Value



Source: SaaS Capital Survey 2019

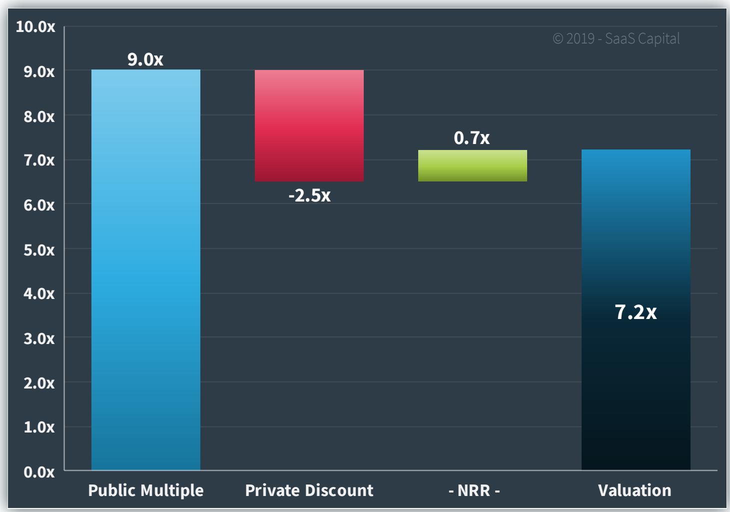
From our 2019 survey data, the median net retention rate (including cross-sell, up-sell, and price increases) for private SaaS businesses is 100%, see *Figure 10*. Above that level, a premium is justifiable. How much of a premium is hard to determine because retention rates are not consistently reported in public or private valuation data, and its impact, as we mentioned, is highly correlated with other value drivers.

All that said, based on the 30 valuation events that we have been a part of, we estimate the impact to be significant for companies that deviate meaningfully from 100% net retention. Less than 85% net retention will undoubtedly lower a business' value, and above 105% will certainly increase it.

In the case of SlowCo, retention is a strength as it is for many vertically focused SaaS companies. It's Net Revenue Retention of 107% earns it a 0.7x multiple upgrade, shown in *Figure 11*.

Figure 11

Retention Impact on Valuation: SlowCo Example



VALUATION DRIVER #4

GROSS MARGIN & REVENUE MIX

Given the revenue generated by your business, how much profit can you make?

Gross margin indicates the potential profitability level of the business per dollar of revenue when it reaches a more mature phase. Gross margin also determines how much cash a company can reinvest back into sales, marketing, and product development and, therefore, indicates the capital efficiency of the business. For these reasons, the less direct costs required to deliver a SaaS revenue stream, the more valuable that revenue is.

> *" The less direct costs required to deliver a SaaS revenue stream, the more valuable that revenue is."*

Our private company survey data indicates that the median gross margin is 74% corresponding to an average mix of license revenue to professional services of 80%/20%. This is also consistent with the average SaaS Capital Index gross margin of 73% for public companies. The costs typically included in the gross margin calculation are: professional service costs, hosting and related personnel costs, customer support, customer success, and any other direct cost associated with delivering the product. For more information, read our blog post *"What Should Be Included in COGS for my SaaS Business?"*

If your SaaS business is generating significantly more of its revenue from services or has a meaningfully lower gross margin than a traditional SaaS company (i.e., your product requires a lot of third party data or services, or you have unusually high hosting costs), your revenue valuation multiple will be lower.

It is possible to convert a revenue-based valuation to a gross margin multiple to quantify the potential impact on valuation. As discussed above, the average private revenue multiple is approximately 28% less than the current SaaS Index multiple of 9.0, and the average private gross margin is 74% (based on SaaS Capital research data.) Using those two figures, we can derive a baseline private company gross margin valuation multiple of 8.8x. *Figure 12* shows how to estimate the valuation impact of different gross margins. This basic approach is useful regardless of what gross margin percentage is assumed to be the base case.

An alternative approach to account for revenue mix and gross margin variations is to assess the value of different revenue streams separately. To do this, and also operate the business effectively, services revenue and license revenue should be isolated, along with the direct COGS needed to support each. This approach is particularly useful for SaaS businesses that can demonstrate significant gross margin contribution from their services work.

SlowCo has an efficient software application and support organization driving an 80% overall gross margin, which justifies a 0.5x multiple premium, as *Figure 13* shows.

Figure 12

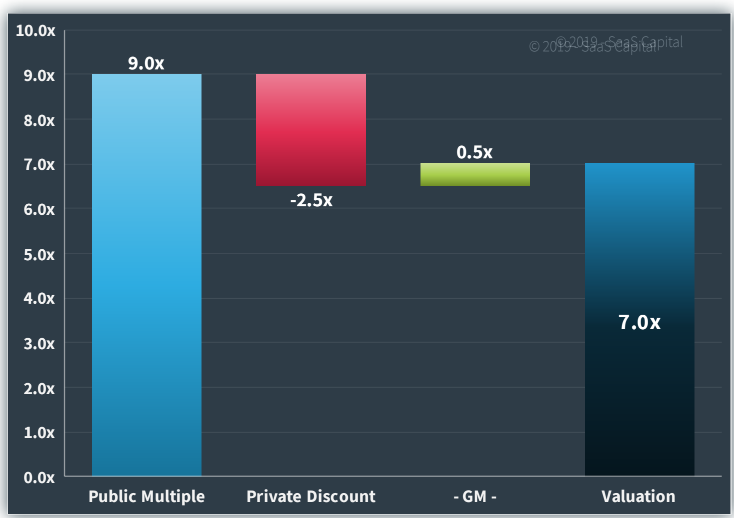
Gross Margin Impact

	AVERAGE SAAS CO
Revenue	$10,000,000
Revenue Multiple	6.5x
Company Valuation	$65,000,000
Gross Margin %	74%
Gross Margin $	$7,400,000
Implied Gross Margin Multiple	8.8x

	LOW MARGIN SAAS CO
Revenue	$10,000,000
Gross Margin %	60%
Gross Margin $	$6,000,000
Gross Margin Multiple	8.8x
Company Valuation	$52,800,000
Implied Revenue Multiple	5.3x

Figure 13

Gross Margin Impact on Valuation: SlowCo Example



VALUATION DRIVER #5

CUSTOMER ACQUISITION EFFICIENCY & UNIT ECONOMICS

If I put a dollar in my SaaS money-making-machine, how much will I get out?

Both investors and strategic buyers are typically looking to continue growing a SaaS business by deploying more capital for sales and marketing. How efficiently the business converts that spending into new customers is highly relevant to both projected future cash flows at maturity, and the amount of capital required to get there. Companies with high customer acquisition costs (CAC) need more capital to grow, and thereby, diminish overall returns whether the buyer is a VC, a corporation, or a public stockholder.

There are many ways to measure the CAC ratio, and for this analysis, we will keep it simple:

CAC Ratio = New ARR from new customers ÷ sales and marketing spend to acquire those customers

In English, how much in annual revenue is generated for each dollar invested in sales and marketing?

This ratio does not include gross margins because these costs are accounted for elsewhere in our analysis, and it does not include a lifetime value (LTV) calculation as that metric is implicitly considered in the retention and growth section. LTV is also a highly volatile metric. You can read more about this volatility in our blog post *A Warning About SaaS Lifetime Value Calculations*.

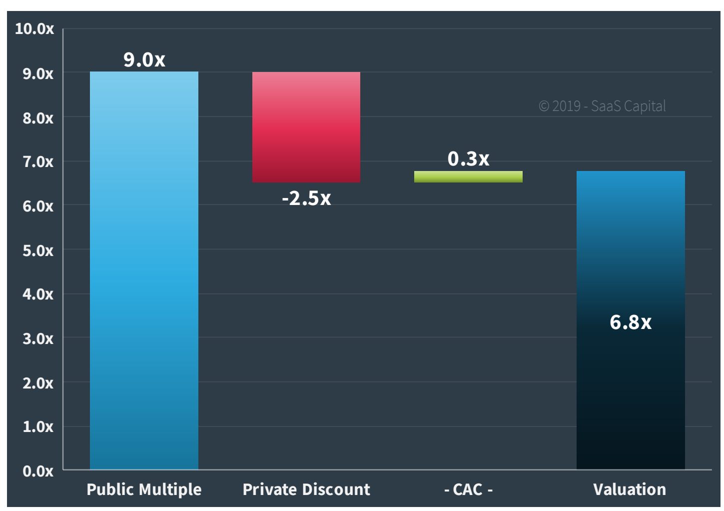
Our 2019 survey of SaaS companies yielded a median CAC ratio of .78. This means that each dollar of sales and marketing spend generated 78 cents of annual recurring revenue. This can also be thought of as a monthly payback period of 15.4 months (12 months ÷ .78).

It should be noted here that this metric is subject to some interpretation and manipulation based upon the costs that are included in sales and marketing spend, what is counted as "new" revenue from "new" customers, and how long is the inherent time lag in the sales and marketing spend relative to new revenue. Therefore, benchmarking this ratio should be done cautiously and with a fair amount of leeway. From a valuation perspective, companies that are inefficient at acquiring new customers and have a CAC ratio below .6 will be valued less, and those that are efficient and have a ratio above 1.2 will be valued higher per dollar of revenue.

Like many vertically oriented SaaS businesses, SlowCo has an efficient CAC Ratio of 2.0 and earns another 0.3x multiple premium, depicted in *Figure 14*.

Figure 14

CAC Impact on Valuation: SlowCo Example



VALUATION DRIVER #6

PROFITABILITY

In the introduction of this paper, we discussed how bottom-line profitability does not play a substantial role in the valuation of a SaaS business, but there are a few scenarios in which its impact is potentially significant.

1. Profitability becomes relevant to valuation when combined with slow growth. Future cash flows from a business that is *both* unprofitable and slow-growing are hard for anyone to quantify. It is very difficult to raise capital for these businesses, and they are generally worth 0.5 to 2.0 times revenue to strategic buyers depending upon retention and product fit.

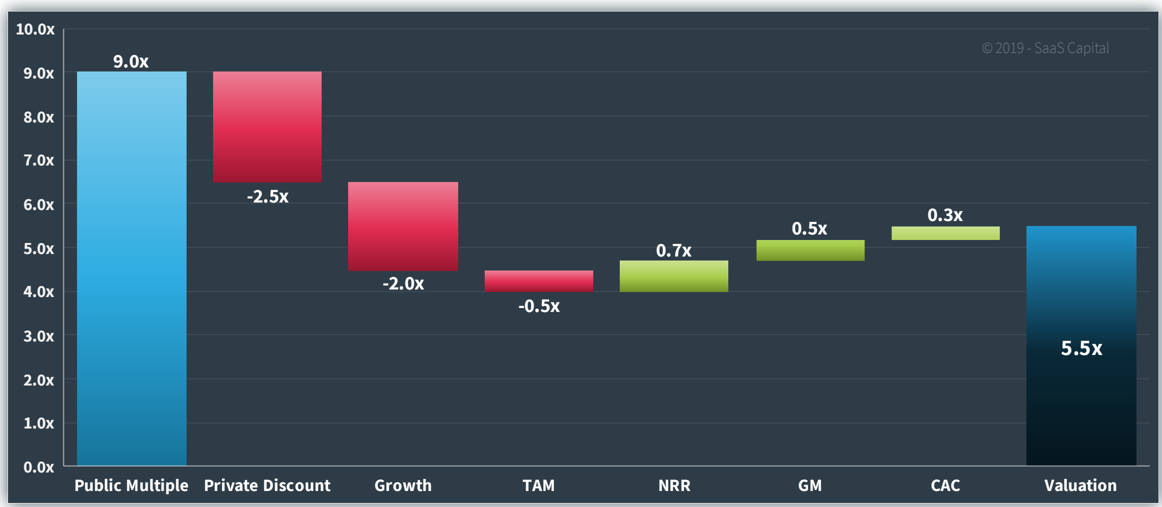
2. Profitability creates optionality for a seller. In other words, when a business does not need additional capital to sustain itself, there is less pressure to sell. Current profitability may or may not factor heavily into the projected future cash flow of the business, but it certainly can have a real-world psychological impact on the motivations of both buyers and sellers.

3. When capital needed to sustain losses in unprofitable business becomes scarce and expensive, profitable firms increase in value.

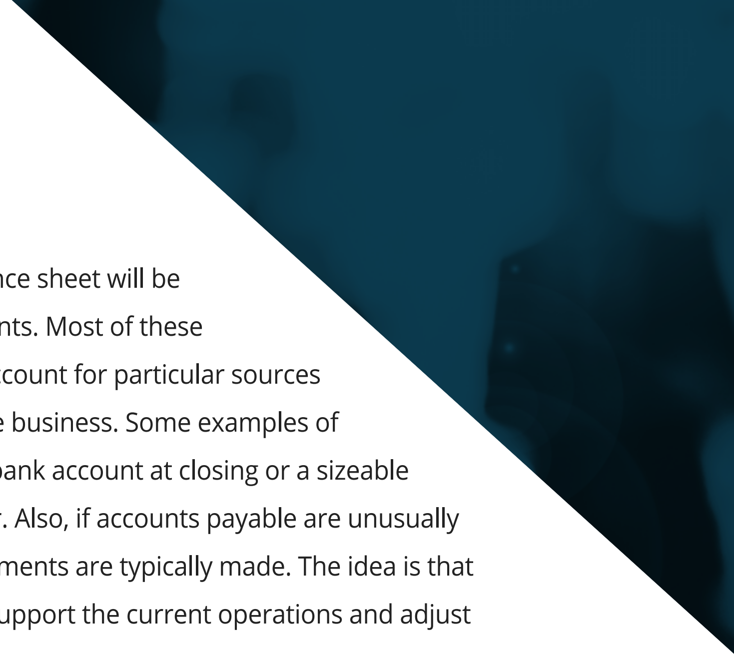
Because bottom-line profitability only impacts valuations in specific scenarios, we do not attempt to quantify its impact, in this paper, but we certainly recognize its importance in some cases.

Figure 15

SlowCo Valuation Summary



Summarizing all the valuation factors for SlowCo on October 1, 2019 yields a multiple of 5.5x and an enterprise value of $27 million, shown in *Figure 15*.



THE BALANCE SHEET

When getting into the final stages of valuation, the balance sheet will be considered, and there will be a myriad of final adjustments. Most of these adjustments are not specific to SaaS and are made to account for particular sources or uses of cash separate from ongoing operations of the business. Some examples of typical adjustments include a large cash balance in the bank account at closing or a sizeable long-term obligation that is being assumed by the buyer. Also, if accounts payable are unusually large, or accounts receivable are abnormally low, adjustments are typically made. The idea is that the buyer will buy a "normal" balance sheet needed to support the current operations and adjust the price for any unusual balance sheet conditions.

What about deferred revenue?

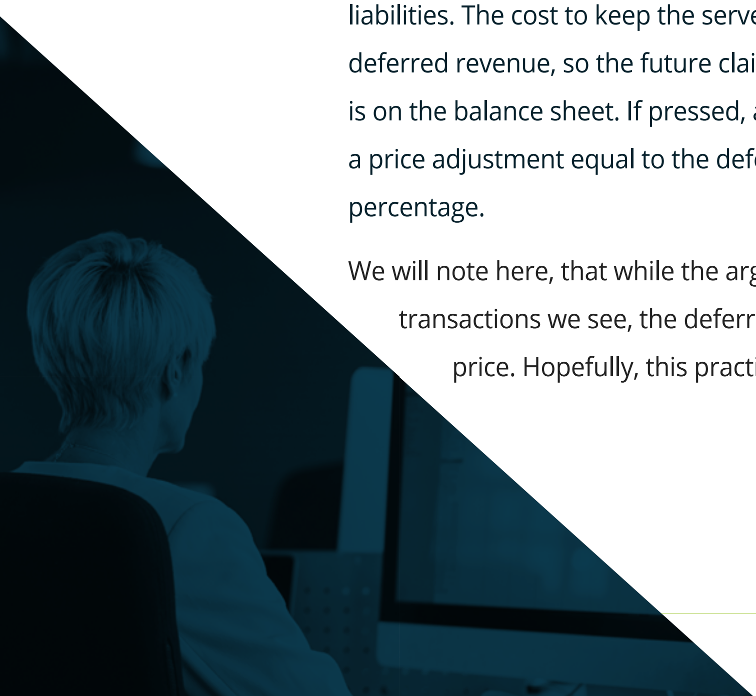
Deferred revenue is a balance sheet item relatively unique to SaaS, and we believe it deserves separate consideration.

Buyers will frequently argue that if they make a purchase based on revenue as a proxy for future cash flows, then deferred revenue represents cash that has already been collected and therefore it should not be considered in future cash flows and should be deducted from the price.

This approach is wrong for two reasons:

1. If the business continues to grow, or at a minimum, maintains current revenue levels, deferred revenue will never be "repaid." It is part of the normal working capital equation of the business and it actually is a source of cash if the business grows.
2. To satisfy the deferred revenue "liability," the company merely needs to provision the service, not write a check as it would do for a bank loan or most other long-term liabilities. The cost to keep the servers up and running is a fraction of the amount of deferred revenue, so the future claim on the company's cash is much lower than what is on the balance sheet. If pressed, an appropriate option you might suggest is to make a price adjustment equal to the deferred revenue balance times the cost of goods sold percentage.

We will note here, that while the arguments above are strong and valid, in 100% of the transactions we see, the deferred revenue balance is subtracted from the purchase price. Hopefully, this practice will change in the future.



OTHER VALUATION DRIVERS

The factors listed above might make valuing a SaaS business seem more like a math exercise than it truly is. In reality, there is a myriad of other factors that can impact a company's value, but they tend to be highly company-specific and are, therefore, difficult to quantify or benchmark. Some of the other major value drivers to be aware of are:

> *"There is a myriad of company-specific factors that can impact a company's value, but their value can be difficult to quantify or benchmark."*

1. **How competitive is the sale or fundraising process?** As noted in the first sentence of the introduction, real valuations are set by buyers and sellers, not consultants, bankers, or white papers.

2. **Is the company a leader in its space?** In the SaaS world, leaders tend to maintain and grow market share and garner a meaningful valuation premium.

3. **Is the company a good strategic fit for a buyer?** Beyond your SaaS company's performance, how might it fit in with a buyer's existing business? What are the synergies? Should the buyer pay the seller for those synergies?

4. **How strong (experienced) is the management team?** This is particularly important when valuing an earlier-stage SaaS business when there is less clear financial data.

5. **Is there a technology advantage, technology debt, or an existing claim on intellectual property**?

All of these factors and others can undoubtedly impact value in a meaningful way; however, the impact is still generally within the context of a revenue multiple premium or discount.

SAMPLE VALUATIONS FROM OUR PORTFOLIO

Throughout this paper, we've been developing the valuation framework, which begins with our public company benchmark and then builds in the appropriate valuation premiums and discounts. We demonstrated the value drivers using the hypothetical "SlowCo," and below we apply the same analysis to two actual portfolio company sales. Note that each valuation exercise begins with the public multiple ***at the time of the equity event.***

Figure 16

Portfolio Company #1

- Public company market multiple at the time of transaction = 4.9x, a 28% discount is reflected in the 1.37x private company discount
- ARR run-rate = $17 million
- Growth rate = 26% (lower than mean)
- TAM = Currently serving niche market
- Net Revenue Retention Rate = 109% (very high)
- Gross Margin = 84% (average, at the time)
- CAC Ratio = .9 (average)
- Valuation = 3.5x from a private equity firm

Figure 17

Portfolio Company #2

- Public company market multiple at the time of transaction = 5.1x, a 28% discount is reflected in the 1.43x private company discount
- ARR run-rate = $45 million (large)
- Growth rate = 230% (extremely high)
- TAM = Niche market, but plausible expansion to a larger market
- Net Retention Rate = 100% (average)
- Gross Margin = 90% (high)
- CAC Ratio = 3.2 (very high)
- Valuation = 9.3x from a private equity firm

CONCLUSION

SaaS companies, like any other, are worth the present value of their estimated future cash flows as determined by a willing buyer and willing seller. For SaaS businesses, however, the best proxy of future cash flows is recurring revenue, not EBITDA, and so they trade based on a multiple of that metric. Because of their smaller size and lack of liquidity, private SaaS businesses generally trade with a revenue multiple that is discounted by 28% from current public SaaS companies.

At the publication date of this paper, an average private SaaS business was worth 6.5 times run-rate revenue. From there, the key drivers of the valuation multiple above or below the average are growth relative to the size of recurring revenue, addressable market size, revenue retention, gross margins, and sales efficiency. Deviations from the mean in these metrics can swing the valuation multiple significantly and cumulatively, with revenue growth rate being the most significant value driver by far.

In understanding the underlying methodology used by buyers and investors in SaaS businesses, operators and owners can better optimize and negotiate an appropriate valuation. Based on our experience, it is a myth that buyers and investors want an uneducated seller. Buyers want to work with a reasonable and educated seller that can quickly and rationally come to a fair range on valuation. From there, the two parties may not ultimately agree on a price, but at least they will have a productive and informed conversation.

ABOUT SAAS CAPITAL

SaaS Capital is the leading provider of growth-debt designed explicitly for B2B SaaS companies. SaaS Capital growth-debt is structured to provide a significant source of committed funding, deployment flexibility, and lower overall cost of capital, all while avoiding the loss of control associated with selling equity. SaaS Capital was the first to offer lending alternatives to SaaS businesses based on their future recurring revenue. Since 2007, we have deployed $209.5 million in growth-debt to deliver better outcomes for our 60+ clients resulting in $753 million in total enterprise valuation created. SaaS Capital has offices in Cincinnati and Seattle.

Visit www.saas-capital.com to learn more

+1 513-368-4814

+1 303-870-9529

info@saas-capital.com