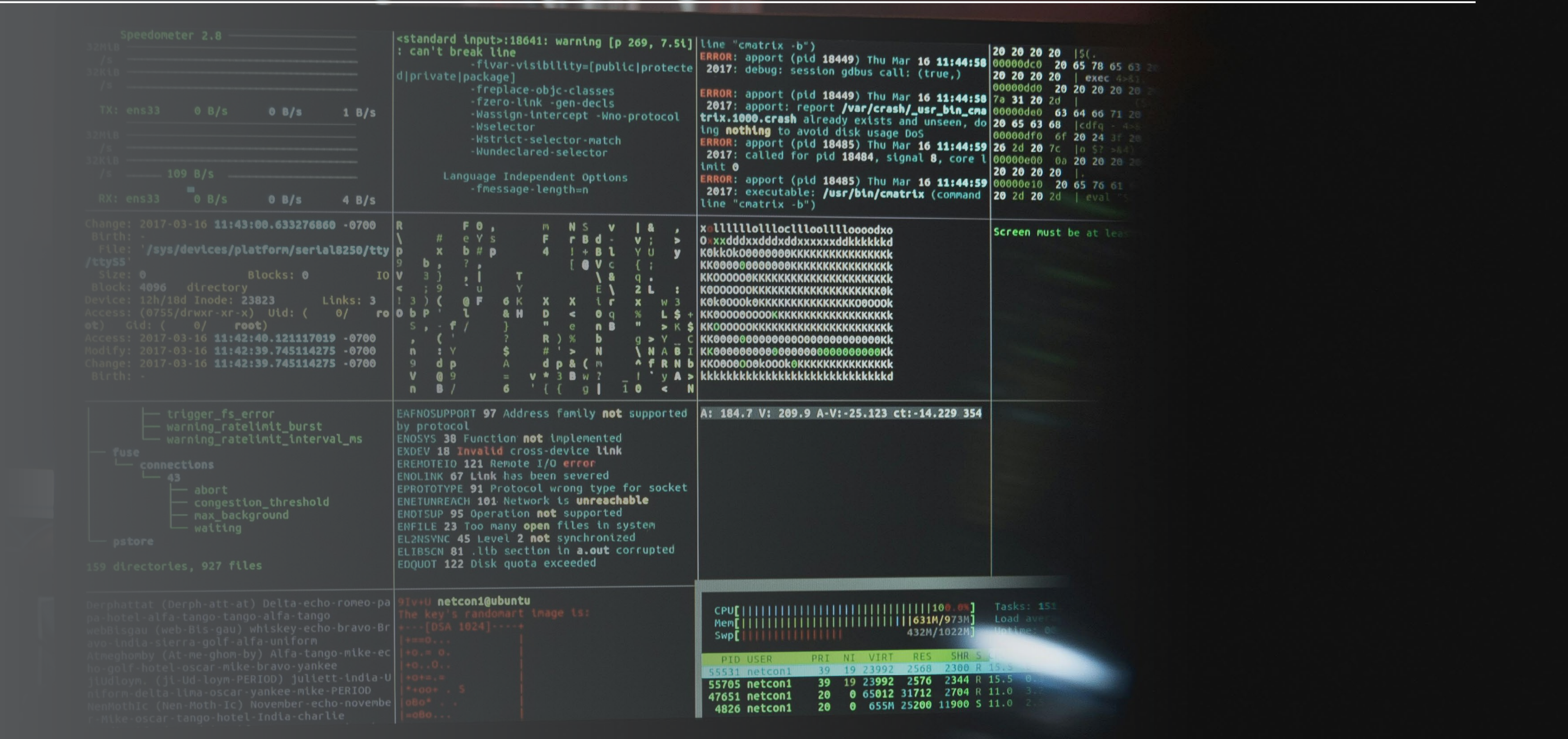


Seizing the SaaS Opportunity

Valuation & Benchmarking

Opening Thoughts

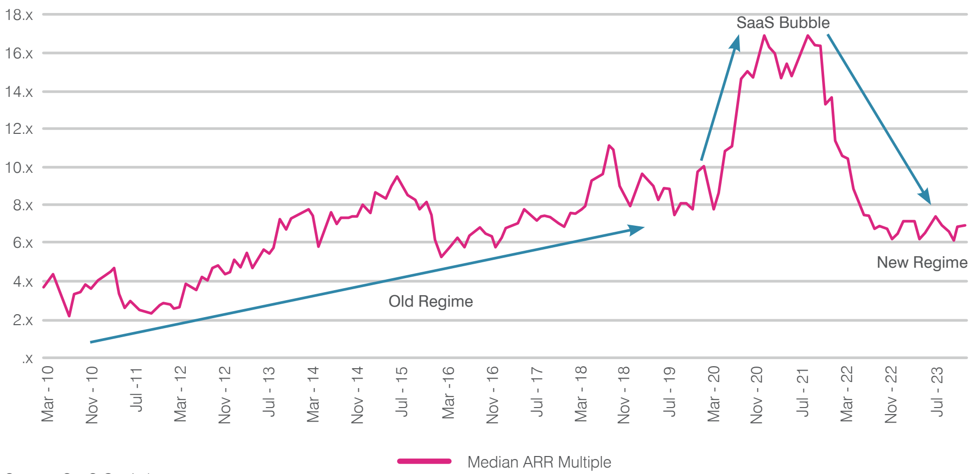
It hardly seems three years since we produced our first SaaS valuation white paper. Times were very different. Cast your mind back – we were in and out of lockdowns, had been told that the world had changed forever and that everything would move to the freedom of the online world.

Everything online boomed, valuations skyrocketed, be that online shopping, home delivery food or software. SaaS deals were happening at an average of 16x revenue, more than doubling. Had the world gone mad? Did the emperor have any clothes?

On the face of it, the rapid reduction in late 2021 / early 2022 suggests yes, indeed many question why valuations of 8x revenue remain valid now.

So, what can we take away from this bubble?

Figure 1: SCI Median Valuation Multiple



Source: SaaS Capital

Let us go back to basics. Company valuations are ordinarily based on the value of their discounted cashflows. Of course, we know that investor sentiment has run roughshod over this concept, with tens of millions of private investors using apps and online trading platforms to demonstrate this. Lock people up, give them no other outlet to spend their cash and we have the perfect ingredients for a bubble.

In the meantime, the professionals, fund managers, etc, cannot help but get a bit greedy and/or get caught up in the hype. It is hard to sit on your hands - you rationalise your decision and just hope you are not left holding the baby.

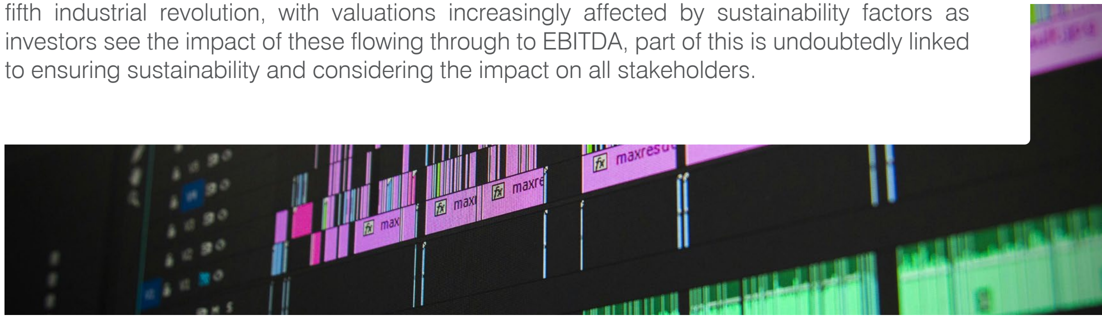
Here is the most common rationale:

- ARR reflects how the business is trading now; this is more accurate than looking at last year's accounts
- Fast growth in ARR into the burgeoning market supports forecasts
- Software companies have a pretty fixed overhead. Once the software is written there are simply the costs of keeping it up to date, the cost of customer acquisition (CAC) and the costs of supporting customers
- Fast growth in ARR rapidly leads to high adjusted EBITDA which, if it were not for investing in new products/sales channels, would equate to accelerating cashflows

So, the rationale is that the ARR multiple is a proxy for discounted future cashflows. In many cases this is true - investors have confidence in the efficient SaaS mechanics and are eager to deploy cash. Drilling deeper behind ARR growth, true value in SaaS lies in retention rates on high margin revenues.

The cycle has of course recently revved up again due to excitement over the integration of AI into products, with the rational that AI will reduce costs, enhance data utilisation and monetisation, and further improve cashflows.

What does all this mean to the owners and investors in SaaS businesses? In this document we look at where valuations originate, reflect upon what makes a successful SaaS business today and consider the areas you can focus on to maximise business value As we enter the fifth industrial revolution, with valuations increasingly affected by sustainability factors as investors see the impact of these flowing through to EBITDA, part of this is undoubtedly linked to ensuring sustainability and considering the impact on all stakeholders.



Overview

Put simply, opportunity abounds and future cashflows will be strong for the best market participants.

Technology spending is expected to rise at its fastest rate in five years according to Pitchbook, giving a plethora of opportunities to business owners and investors within the tech and (more specifically) the SaaS space.

Forbes commented that the global SaaS market is expected to reach US $680bn by 2030, a compound annual growth rate of a whopping 18.7% and testament to SaaS's ability to provide convenient solutions across all sectors. An anticipated 17.7% increase in expenditure into the space will, according to PWC, pump an additional £174bn into the global economy in 2024, through job creation, business growth and the economic multiplier effect.

The UK SaaS market is expected to grow by a CAGR of 21% (2024-2029), and result in a market volume of £33bn by 2029. The UK has the second largest IT spend globally and a strong appetite for SaaS products. The dynamism of the UK SaaS market leaves space for agile-midmarket or emerging players to cause disruption without competing directly with the huge B2B or B2C players.

Growth in the SaaS market continues to attract significant investment, both in the domestic market and internationally. SaaS offers great investment returns across all sectors as its software boosts productivity and often enables dramatic reductions in costs of sale and/or fixed overheads, increasingly reducing headcount or the need for contracted out services. For instance, financial businesses increasingly use Regtech SaaS to streamline and automate the compliance process, reducing the need for dedicated compliance teams. When this is integrated with AI, the synergies are starting to produce smarter, more streamlined solutions.

Market Trends - The Big Picture

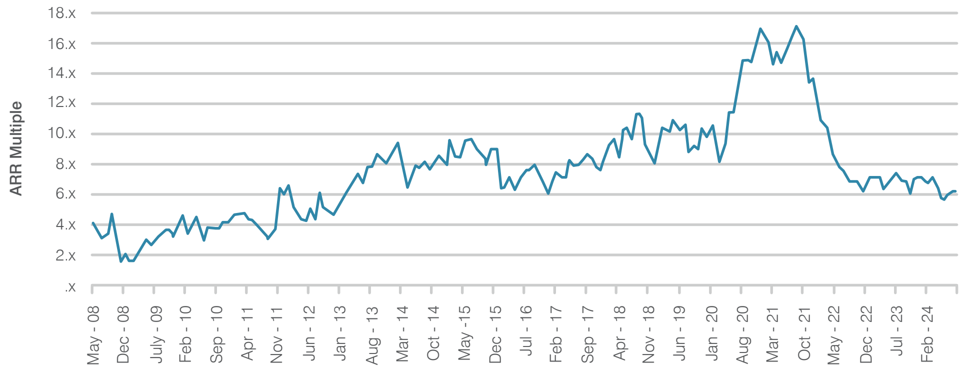
In this new era of SaaS, companies are focusing on retention.

The 'old regime', 'SaaS bubble' and 'new regime' are the coined terms for the distinct stages that the SaaS sector has experienced since its inception in c.2007. The SaaS bubble was driven by the pandemic – and these high valuations that we saw in this period were positive for the sector but should be considered separately from valuations now. Investors and providers of capital are now reviewing valuations in a way that does not consider this distinct event.

SaaS Capital tracks public companies to produce the median ARR multiple each month for its index. Currently, the index ARR multiple is sitting at 6.2x.

Figure 2 shows how this multiple has changed since the index started tracking public SaaS companies in 2008.

Figure 2: SaaS Capital Index



Source: SaaS Capital

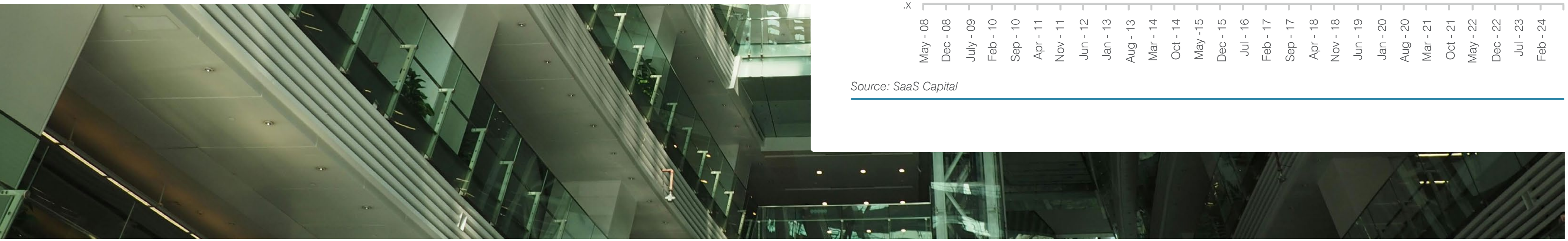
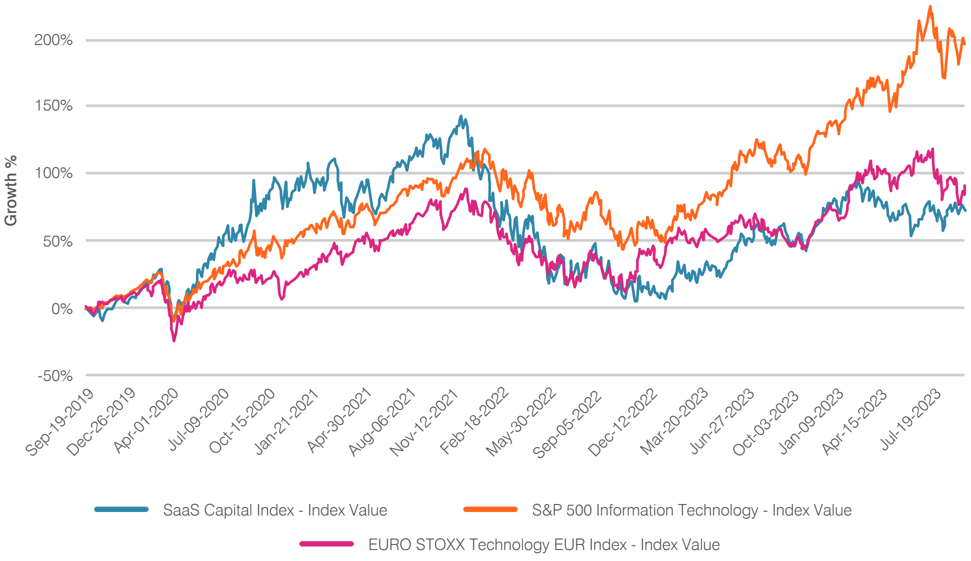


Figure 3 shows the performance of the SaaS Capital index against the S&P500 and Euro STOXX listed software & technology companies. Whilst the SaaS vertical is maturing, it is yet to consolidate to the same degree as the broader technology sector.

Figure 3: SaaS Capital performance against S&P500 and STOXX Europe Technology indices

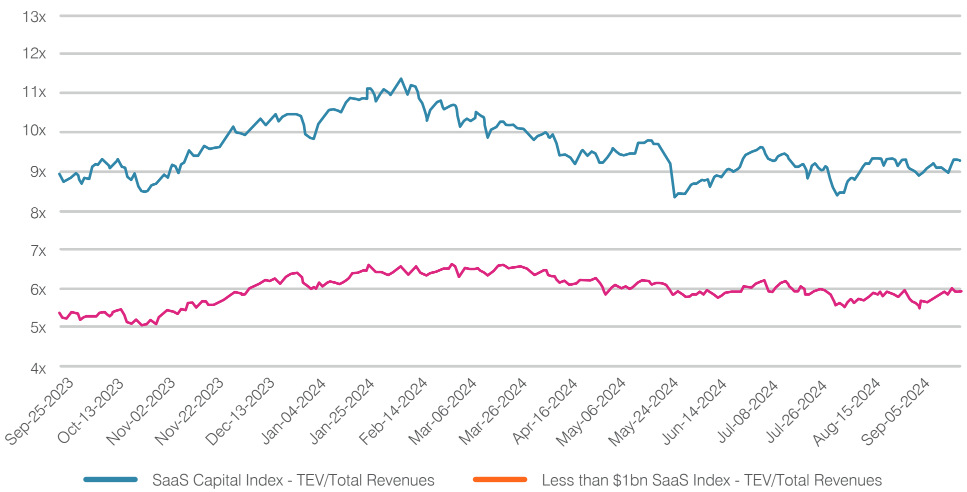


Source: CapIQ

Tech companies are continuing to perform well across the board, and although many were affected by the bursting of the bubble at the end of 2021, the industry is holding its own. Software & technology STOXX and S&P500-listed companies are continuing to outperform the wider indices.

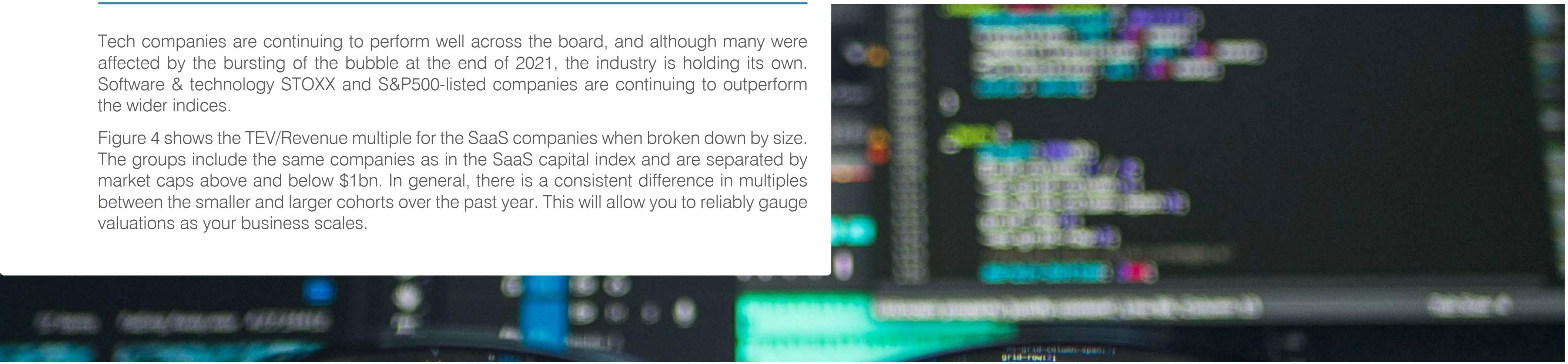
Figure 4 shows the TEV/Revenue multiple for the SaaS companies when broken down by size. The groups include the same companies as in the SaaS capital index and are separated by market caps above and below $1bn. In general, there is a consistent difference in multiples between the smaller and larger cohorts over the past year. This will allow you to reliably gauge valuations as your business scales.

Figure 4: Revenue mulitples for SaaS Companies above and below US $1bn market cap



Source: CapIQ

Overall, growth rates for these larger public SaaS companies are slowing – reflecting the sector's maturity. As with other established verticals with less growth momentum, players will likely become more acquisitive and seek inorganic growth, as we saw in telecoms after the .com boom.

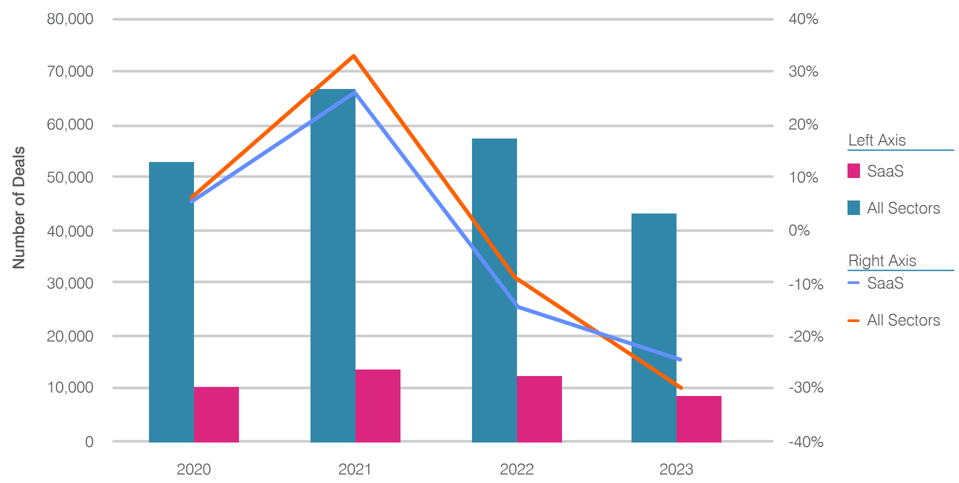


How do Private Companies Differ?

Whilst the public markets provide a helpful backdrop to valuing in the mid-market, not least because many of the quoted parties are highly acquisitive, they do not of course tell the full story, with a variety of factors impacting the picture. Notable among these is scale, a factor even within the public markets, as well as lack of liquidity.

As of 2024, the US market is generally showing private SaaS businesses trading at a discount of c.40% to their listed market equivalents *(Source: SaaS Capital)*. Whilst this discount may be higher than a couple of years ago, this should be considered in accordance with the wider economic outlook.

Figure 5a: Global deal count - deals <£500m

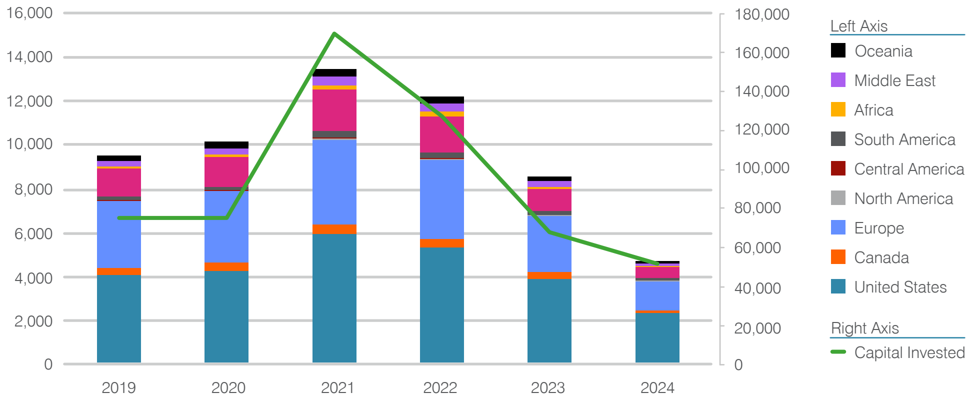


Source: Pitchbook Data, Inc.

Figure 5a demonstrates fluctuations in the number of deals in the SaaS vertical against the wider market in deals <£500m. The percentage change in deal count (as illustrated as the line component) shows that, whilst SaaS related activity has fallen, it appears to be slightly less impacted than the wider market.

Looking at the breakdown of global SaaS deals in figure 5b, a high proportion (c.90%) are funded by venture capital, though with VC deals across the board taking a hit, deal activity up the vertical has slowed. VC had a particularly rough 2023 due to a lack of successful exits and several failed IPOs in 2022 leaving equity investors more hesitant to deploy cash. VC funded SaaS deals declined by 10% from 2021 to 2022, then by 32% from 2022 to 2023. This is relatively aligned with the decline in deal activity the vertical experienced as a whole. Interestingly, VC-funded SaaS deals held up well against a global decline of 35% in 2022 across all industries, before a steep decline in 2023 more in line with the global trend.

Figure 5b: Regional deal count & capital invested in SaaS deals, where deal size <£500m



Source: Pitchbook Data, Inc.

Unsurprisingly, the US consistently sees the most SaaS deals globally, with a high appetite from entrepreneurs to set up shop in Silicon Valley, New York and DC, with a hope to list in the States.

The UK SaaS economy is the most successful in Europe, and in areas such as Fintech, sits second in the world to the US. London is a fertile area for new SaaS players, with an ecosystem fit to nurture future unicorns. The financial districts, proximities to top universities, and the Old Street tech hub mean that SaaS founders can easily access top talent and resources to grow their businesses.

Valuation & Benchmarking

Annualised Recurring Revenue

A few years ago, ARR was the pre-eminent metric of value for SaaS companies as the sector was much younger, albeit referenced against its constituent parts linking CAC, revenue growth rates and churn. Since individual client revenues are typically relatively small in the first instance and such businesses frequently have significant front-loaded costs such as CAC and R&D, they are often slow to build profitability.

As a result, the logic is that business profitability lags well behind the 'real' traction and stage of growth of the business.

Now, as SaaS companies have matured, generating more data to support such analysis, valuations place increasing weight on profitability, such that for a given ARR multiple, a valuation today is likely to be supported by more identifiable profit metrics than, say, 5 years ago, albeit typically linked to a lower growth rate.

A pre-requisite of an ARR anchored approach is a "sticky" repeat revenue base, where new revenues build on previous wins at a high margin and hence feed substantially through to profit. Thus, a company needs to demonstrate its future profit-to-cost ratios will remain competitive, with low overheads as the company expands and matures. Metrics such as CAC: Client Lifetime Value (LTV) that support the likely trajectory of future profitability and cash generation have therefore become much more fundamental to investors' consideration of value. If a buyer can satisfy itself as to the revenue growth trajectory alongside these other metrics, it can support better the conversion into future profits, reducing risk and hence increasing value.

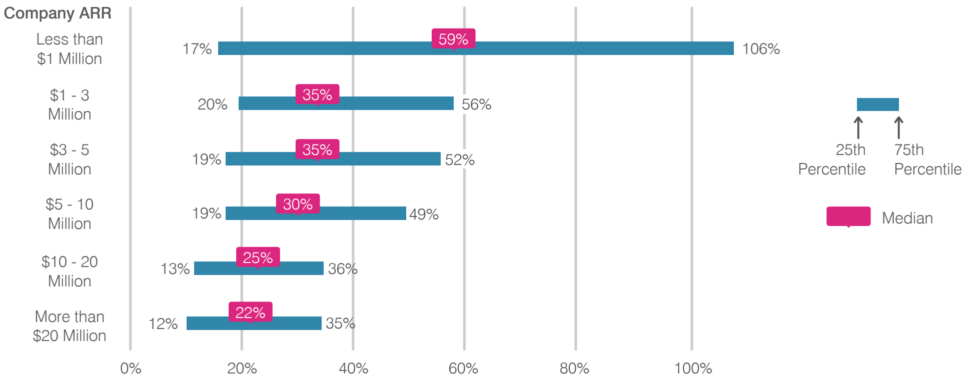
As ever, nuances abound, making comparison of multiples with averages for the sector, or even with peer transactions, likely to be misleading without a really good handle on the underlying components. {For a wider discussion on these see the Polestar white paper: Understanding SaaS Value Metrics.}

Notwithstanding, it is human instinct and helpful to business development to give some idea of metrics against which you and external investors might assess your business performance.

Growth

What is "good" growth? Drilling down a little, figure 6 illustrates the median ARR growth rates by size, together with the numbers at the 25th and 75th percentile points. A top 25% company with ARR of $1m needs to be showing growth of 106%+ whereas at over $20m, it would be in the top quarter from 35% growth.

Figure 6: Expected Growth by Company ARR

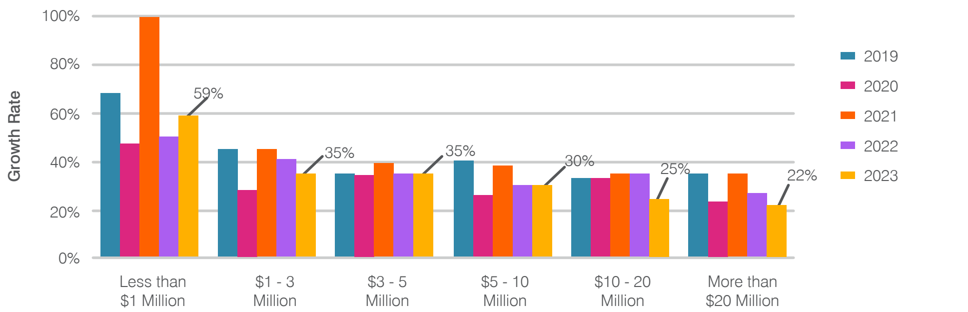


Source: SaaS Capital

Interestingly, looking across the time periods, Figure 7 highlights that for all size ranges the median had fallen to some degree since pre-covid. This reflects the above mentioned shift to quality, profitably-focused growth across the sector.

Smaller businesses, presumably more agile, grasped the opportunity presented in the covid period, as users accelerated decision making to find solutions that could be implemented quickly and mean growth accelerating strongly, whilst larger, more mature businesses, though experiencing some acceleration on average, remained relatively constant.

Figure 7: Median Growth by ARR

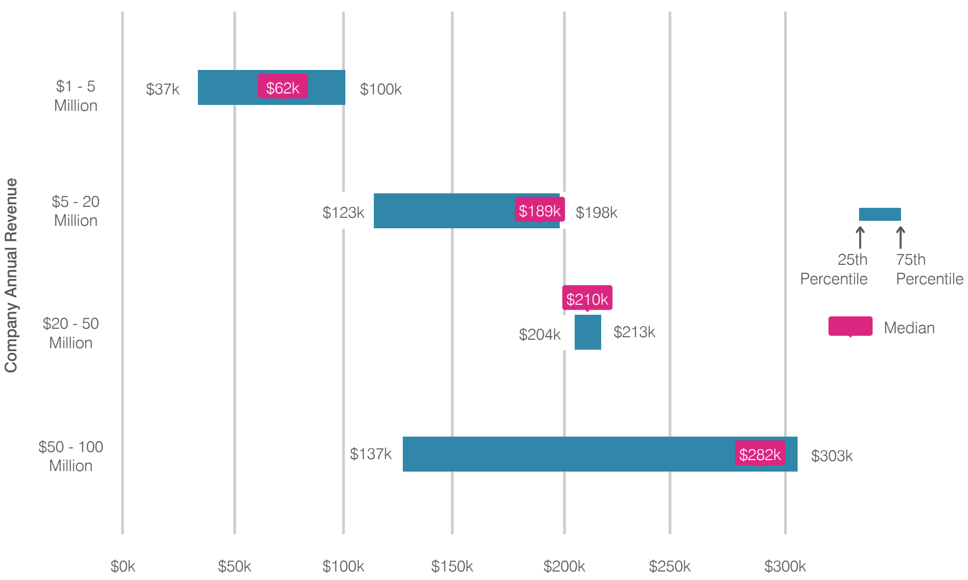


Source: SaaS Capital

This shift to "profitability support" extends even to pre-profit, venture stage businesses, with investors looking for hooks to support the trajectory through a variety of profitability pathway metrics, which include:

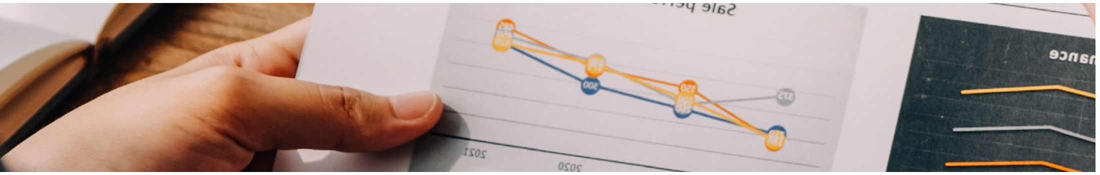
ARR per employee, which would be expected to increase with scale, reflecting the high margin nature of a typical SaaS business. As shown in Figure 8, as businesses scale and become more established, the median moves towards the 75% level.

Figure 8: ARR per Employee by Business Size (Total Annual Revenue)



Source: B2B SaaS Benchmarks 2024 Report, Presented by Mosaic

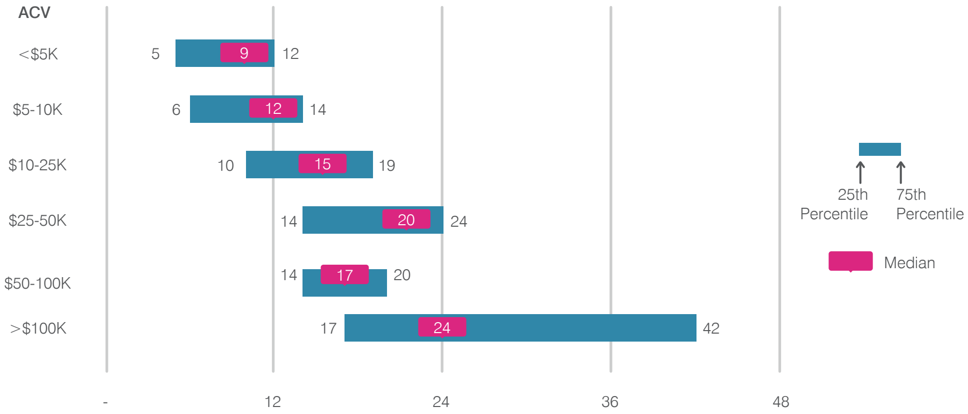
Burn Multiple, a measure of how efficiently the growth is being generated and looks at net burn (net cash outflows) divided by net new ARR. As a broad rule of thumb, investors are looking for something in the 1-2 range is, with anything under 1 likely to position the business as a standout potential investment. Conversely, above 2 is likely to raise some level of concern, especially after the initial set up phase.



Customer Accretion metrics, such as:

- CAC Payback Period, how many months the customer must be retained to pay back the initial customer acquisition cost expectations vary significantly depending on the annual contract value (ACV) of the solution being sold.

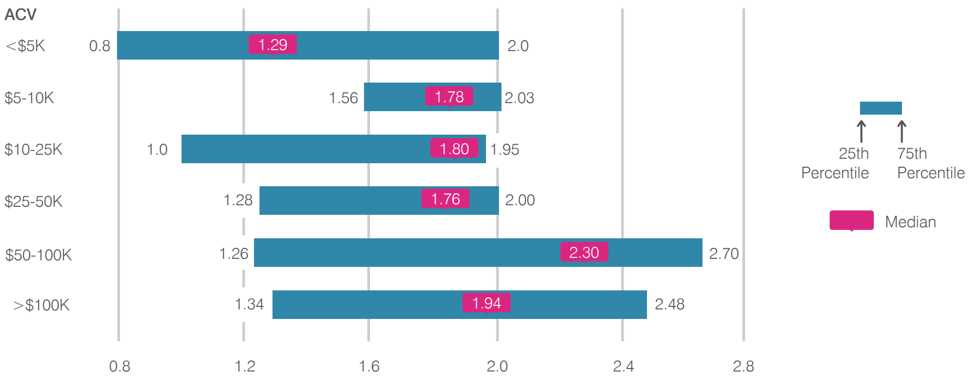
Figure 9: CAC Payback Period in months by ACV



Source: B2B SaaS Benchmarks 2024 Report, Presented by Mosaic

- New Customer CAC ratio, the spend required to acquire £1 of ARR. As shown in Figure 10, this also tends to increase with the level of commitment required from the customer, reflecting the spend involved. Investors therefore consider this in line with the ticket price of the software.

Figure 10: New Customer CAC Ratio



Source: B2B SaaS Benchmarks 2024 Report, Presented by Mosaic

Conclusion

The changes to the market over the past five years have greatly influenced valuations and investor attitudes towards it. Now that the focus is more on steady, sustainable growth, and the expectation of a clear, considered strategy, SaaS players need to reflect on how best to demonstrate their true value and profit potential.

You may find Polestar's SaaS white paper 'Understanding SaaS Value Metrics' helpful this considers a range of metrics in greater detail to consider how different parties might assess your business and what steps you might therefore take to maximise shareholder value for either exit or next round funding.

Notwithstanding the modified approach, opportunities to automate are still promoting strong spending by businesses and individuals and hence continue to drive appetite across both trade and the investment community. With the further development of such solutions and the incorporation of AI optimisations, we expect this theme to continue, particularly as larger organisations look to consolidate to enhance the collection and use of data to drive value enhancements.