18 FACTORS

TO TRACK WHEN VALUING YOUR SaaS COMPANY

SaaS companies have a wealth of information to assess when determining the viability of their business. However, all that data can start to feel overwhelming when it's time to consider a sale of your business and how to assess fair market value.

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YOU MIGHT ASK YOURSELF QUESTIONS LIKE:

What metrics really need my attention?

Is it more important to focus on growth or profitability?

What is gross margin, and why is it commonly miscalculated?

What happens when you aren't excelling in all metrics?

Over 30 years of watching the market expand and evolve.

Software Equity Group (SEG) provides M&A advisory services to a select number of high-quality software and SaaS companies each year and maintains industry leading success rates. We attribute this high percentage to deep domain expertise and our willingness to invest time and resources in getting to know each client's business in considerable detail during the years preceding engagement.

Kris Beible, SEG's executive vice president, is a key part of that team. From spending over a decade meeting with hundreds of software companies every year, he knows which factors matter most to buyers and advises companies on which metrics they need to generate, improve, or maintain to achieve an optimal valuation and strategic outcome.

In this white paper, we'll take a look at the key metrics Kris believes SaaS companies need to be aware of to measure their readiness for a strong valuation and successful future exit.

THE BREAKDOWN

Quantitative vs. Qualitative

SEG'S SaaS VALUATION

SCORECARD

While there are many possible indicators of a company's overall performance, our scorecard focuses on the **18 factors that matter most in SaaS company valuations.**

WEIGHTING	QUANTITATIVE FACTORS	POOR	UNDERPERFORMING	SOLID	EXCELLENT
High	ARR / Recurring Revenue Growth	< 10%	10 - 20%	20 - 30%	30 - 40%+
High	Rule 40	< 10%	10 - 20%	20 - 40%	40%
High	Gross Revenue Retention Rate	< 70%	70 - 80%	80 - 90%	> 90%
High	Net Revenue Retention Rate	< 85%	85 - 90%	90 - 100%	> 100%
High	LTV : CAC	< 3.0x	←	→	8.0x - 10.0x
Medium	% Recurring Revenue	< 50%	50 - 70%	70 - 90%	> 90%
Medium	Gross Margins	< 60%	60 - 70%	70 - 80%	> 80%+
Medium	Client Concentration (Top 10)	< 75%	←	→	< 20%
Low	Total Revenue	< $5M	$5 - $10M	$10 - $20M	$20M+
Low	EBITDA Margin	< 10%	10 - 20%	20 - 30%	> 30%

WEIGHTING	QUALITATIVE FACTORS	POOR	UNDERPERFORMING	SOLID	EXCELLENT
High	Delivery Model	License / Services	←	→	Cloud / Service
High	Product	Commoditized	←	→	Differentiated
High	Technology	Legacy	←	→	Leading Edge
Medium	Market Growth	< 5%	←	→	> 15%
		Low	←	→	High

We divided the factors into two categories: quantitative and qualitative. From there, we've provided a range from "poor" to "excellent" for each factor, weighted by importance.

Don't be surprised if individual advisors, buyers, and investors have different measurement preferences. SaaS financial figures tend to be complex because, as SaaSOptics points out, [SaaS businesses rely on sustained growth differently] than traditional businesses do. We suggest using the scorecard as a guideline for tracking some of the most important factors while still ensuring all your other data is correct and tracking in the right direction, as well.

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Medium	Market Growth	< 5%	←	→	> 15%
Medium	Market Attractiveness	Low	←	→	High
Medium	Management Team	Less Experienced	←	→	Strong, Deep
Low	Total Addressable Market	< $500 million	←	→	$1 billion+
Low	Market Position	Limited	Low	Medium	High

WEIGHING QUANTITATIVE FACTORS IN SaaS COMPANIES

Of the two categories, quantitative factors are more black-and-white figures, less open to interpretation. While there is some flexibility in what a person considers "solid" versus "excellent," these guidelines provide a general idea of your quantitative strengths and weaknesses.

1) ARR / Recurring Revenue Growth (High)

A business's ARR is among the most important metrics to buyers and investors, particularly when evaluating companies on the smaller end of the software market. (At SEG, we consider companies with $5-50 million in revenue to be in that category.)

"If you're a software business, we're looking at your ARR, revenue growth, and the momentum of the business," Beible said. "We're primarily focusing on ARR growth. The reason is that organizations with strong retention metrics can sell on ARR as a leading indicator for the business."

SaaS companies showing at least 30-40% growth in annual recurring revenue are in an excellent position with regard to how their business will be valued.

2) **Rule of 40** (High)

Weighing the importance of growth versus profitability presents an interesting puzzle. As Allen Cinzori, SEG's managing partner, recently pointed out, "The higher growth companies will be of more value [when valuing SaaS businesses]. How does that have an impact when you start talking about profitability? High growth companies may not be making money, whereas those with lower growth may be making money."

This brings us to the Rule of 40. The Rule of 40 (a calculation of adding your revenue growth and EBITDA margin percentages together) is "a way to measure the efficiency with which companies are growing," according to Beible. Buyers are typically more interested in SaaS companies with a growth rate and profit margin totaling 40% or higher.

Because that 40% is the result of a combination of factors, there are different ways to achieve it.

For example, both of the following scenarios follow the Rule of 40:

- a highly profitable business with 0% revenue growth and 40% EBITDA margin
- a higher growth business with 40% revenue growth and 0% EBITDA margin

"Generally speaking, growth is more highly valued than profit generation in the lower end of the market," Beible explained. "So, naturally, the business with 40% revenue growth in that example will see a more significant premium."

The higher growth companies will be of more value [when valuing software businesses].

- Allen Cinzori, SEG

3&4) **Gross Revenue Retention Rate** (High) **& Net Revenue Retention Rate** (High)

"Generally, when we're talking about retention metrics, we look at lost, gross, and net dollar retention. We measure that on an annual recurring revenue basis and this is measured year over year, or December over December," Beible said.

Here's a simple example:

"A **loss for retention** measures how many dollars you have lost compared to starting ARR. So, if I started with $10 and lost $1, my lost retention is 90%.

Gross includes downgrades or reduced usage, and you would add that to your loss. Maybe I have a dollar of reduced usage or downgrades. I'm really at 80% gross dollar retention.

Net includes upsells or increased usage. For example, I have $3 additional revenue that I'm bringing in from existing customers. I go from $10, down to $8, and then back up to $11. This does not include any new customer wins and it measures your existing customer base. If your net dollar retention is above 100%, your revenue is growing each year, even if you don't sell another new customer."

Essentially, gross revenue retention demonstrates a company's ability to retain customers, so the figure will never exceed 100%. SaaS companies hoping for a high valuation should aim for 90% or greater gross revenue retention and over 100% net revenue retention. In terms of what SEG looks for, Beible focuses on gross revenue retention.

"If you show [buyers] a business with no leaks in the bucket, and it's all additive, they will be really excited about that," he said. "Whereas if the business has many leaks in the bucket, you need to replenish that, and it will be more costly. The compounding effect of that is massive."

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- Kris Beible, SEG, EVP

5) **LTV:CAC** (High)

The ratio of a SaaS company's customer lifetime value (LTV) to customer acquisition cost (CAC), usually presented as LTV:CAC, is critically important because it 1) indicates the company's customer profitability, and 2) shows the effectiveness of marketing efforts.

Investors want to see room for growth without having to regularly increase marketing costs. SaaS businesses with an LTV:CAC ratio of 8.0-10.0x or higher are in an excellent position.

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- Kris Beible, SEG

6) **Percent Recurring Revenue** (Medium)

Recurring revenue is the most reliable portion of your company's total revenue. As we've written in the past, "Recurring revenue gets respect when the economy is strong, but in lean times, when new subscriptions are scarce and upgrades slow, recurring revenue is the ultimate life raft most other industries lack."

Because recurring revenue represents a consistent and dependable revenue stream, buyers and investors view a higher percentage as a sign of stability. We consider SaaS companies with anywhere from 70% or greater recurring revenue to be in a solid to excellent position.

7) **Gross Margins** (Medium)

Despite being one of the most important metrics in SaaS valuations, gross margin is often miscalculated—at least in the sense of how the market will interpret it.

"Probably 70% of the companies we see are not calculating gross margin in accordance with how we think the market will see it," Beible said. "The most common issue we see is that they are not allocating labor support costs in the cost of goods sold, and instead, they are tracking it as an expense.

Gross margin is a strong indicator of a SaaS company's scalability, so calculating this accurately is extremely important. Beible also pointed out that it's "one of the three major inputs to calculating the lifetime value of your customer base, and you've got to get that right."

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- Brad Weekes, SEG

8) **Client Concentration (Top 10)** (Medium)

We look at the business's top 10 clients to measure client concentration. Ideally, your revenue is spread across as many customers as possible so that any individual loss is considered minor. At SEG, we look for a company's top 10 clients to make up less than 20% of their revenue.

9) **Total Revenue** (Low)

It may seem counterintuitive to give less weight to total revenue on our scorecard, but its value makes sense given the market's preference for growth. Additionally, total revenue on its own doesn't illustrate the customer experience in the same way retention metrics can.

Let's say a SaaS company shows $10-20 million in revenue–what's driving this figure? Is it boosted by an influx of new customers? Are current customers renewing subscriptions and purchasing upsells? Or are customers churning regularly, requiring your company to spend more on marketing to acquire new customers?

While tracking revenue is vital, it's also important to understand the factors behind the metric.

10) **EBITDA Margin** (Low)

Similar to how we evaluate total revenue, EBITDA is another metric that tells a more complete story when combined with other metrics. In one of our posts on the topic, we explained, "EBITDA is a measure of a company's earnings and is used in conjunction with revenue, cost of goods sold/gross profit margin, and net income to assess a company's overall financial performance."

Knowing your correct EBITDA (including the appropriate add-backs) can make a huge difference in showing your company as profitable or break even. (Especially since EBITDA is used to figure your company's Rule of 40, one of our highly valued metrics.)

A low EBITDA margin won't necessarily have a severe negative impact on your valuation, but buyers tend to look more closely at SaaS companies with margins of 30% or greater.

BEFORE YOU START:
KNOW YOUR GOALS

Before the M&A process begins, Beible asks every founder what their goals are for the transaction. A successful exit will look different depending on each company's (and individual's!) particular goals.

A few basic goals may include:

- Retirement
- Financial de-risking event
- Finding a partner to help drive growth
- Other passions / interests

Entering the M&A process with clearly defined goals puts you on a clearer path to a successful exit.

INTERPRETING QUALITATIVE FACTORS IN SaaS COMPANY VALUATIONS

The qualitative factors we examine rely on accurately reading trends and seeing where the market is heading. Investors and buyers are interested not only in what your product is today, but also in how it will fare in the future.

11) **Delivery Model** (High)

The on-premise delivery model has been around for decades, and while it still works, it's not the most sought-after deployment method as it once was.

Cloud services are much more attractive to the market and yield higher valuations. The COVID-19 pandemic and subsequent remote/ hybrid workforce swiftly demonstrated the need for flexibility and easy software adoption on a larger scale. As cloud services continue to evolve to meet the needs of a still-changing workforce, the potential for growth with this kind of business is significant.

12) **Product** (High)

Product is one of the most significant determining factors in whether your SaaS business is highly valued. The key characteristic here is differentiation.

"This ties in with the retention metrics," Beible said. "For example, how difficult is it to move to a competitive solution for you as a business? The more differentiated the product offering is, the higher the switching costs for your end customer."

He added, "A super-verticalized mission-critical ERP business management offering for the enterprise will typically see more sustainable metrics than a generic CRM product for the masses. They have to fight with large organizations with endless amounts of capital and lower switching costs."

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13) **Technology** (High)

It might go without saying, but leading-edge technology is more highly valued than legacy tech in SaaS valuations. It goes back to 1) growth, and 2) product differentiation. Buyers are looking for companies to provide new, innovative services that today's enterprises need to stay competitive in their respective industries.

14) **Market Growth** (Medium)

Knowing your market growth rate not only helps you set company goals in the short term, but also helps potential buyers and investors get a sense of how sustainable your company will continue to be in the industry.

The market growth rate should instill confidence in a company's potential longevity. In the SaaS space, we're most excited about companies with greater than 15% market growth.

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15) **Market Attractiveness** (Medium)

In terms of the SaaS market's potential for growth, investors can generally feel confident the market will continue its upward trajectory, ultimately making the market more attractive to buyers.

However, not every service is the same, and not every variety of SaaS products will experience similar growth - even within a strong and growing market. Monitoring your competition and the overall reception of new entries in the market is key to presenting where you stand.

16) **Management Team** (Medium)

Buyers and investors want to see that a company's leadership team has successfully executed it's business plan in the past and has the right skills to move the business forward.

A few questions for SaaS founders to consider when evaluating their leadership teams include:

- Does our team have a proven history of success?
- What does our leadership team turnover look like?
- Is the current team on the same page about where we're headed and how we'll get there?
- Do you have a clearly defined succession plan?

A cohesive team with experience in the space will generate more interest from potential buyers.

17) **Total Addressable Market (TAM)** (Low)

With a total addressable market (TAM), investors want evidence that there's room to grow the business. Not only is it unrealistic to expect one company to capture 100% of the market, but we've seen that buyers are actually more concerned if there isn't much room left in the market.

"You need room to grow, and you don't need to be a billion-dollar TAM," Beible said. "In fact, in many cases, investors would like your TAM to be $100 million, maybe $200 million, because it's small enough that you can build a great defensible business with plenty of room to grow and expand your TAM over time."

Cinzori further explains that the size of the business plays a role as well. "For a $50 million ARR business, $100 million TAM will not be that interesting… When TAM gets a bit smaller, you have something that perhaps is not as attractive for the next company to come in, so the perceived barriers are higher."

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18) **Market Position** (Low)

Simply put, market position refers to where your software business is in relation to your competitors.

Your business doesn't have to be the largest in the market to have good positioning. It's more important that you can show 1) how you're competitively differentiating yourself in the space, and 2) that you have a plan for continually improving your position and capturing more market share.

"It's nuanced differently for all sorts of businesses, but ideally, you have a strong product offering with enthusiastic customers and good differentiation. That typically means that you have carved out a nice position for yourself that's defensible, and you will continue to grow over time," Beible said.

Many factors go into evaluating a SaaS company, and no company is perfect. But by reviewing and tracking these metrics, building on your strengths, and improving your weaknesses, you'll be in a better position down the road when it's time for an exit event.

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DRIVEN BY THE WINDSHIELD,
NOT BY THE REARVIEW MIRROR

Some SaaS companies considering an exit simply aren't ready yet. Extra time gives them the opportunity to focus on strategic areas where they can improve. It's a matter of understanding that, as Cinzori notes, "M&A and private equity recapitalizations are not like venture capital. They're not driven by the windshield of the car, but driven by the rearview mirror of the car."

Beible elaborates: "If you spend money on the product development of a whole new platform, you want to get paid for it from an exit perspective. Until it starts generating returns through sales and retention, it's unlikely that any buyer will be willing to pay the premium or the price that you may want for that. It needs to show up in the rearview mirror. Once you have enough visibility in the rearview mirror, then the buyers want to look at the windshield."

SEG | Software Equity Group

Our team of experienced M&A advisors understand value drivers.

We can provide insight on how to make your company more attractive long before you're ready for a liquidity event. Then we'll bring the best buyers to the table, handle the negotiations, and conduct due diligence so you achieve the best possible outcome.

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