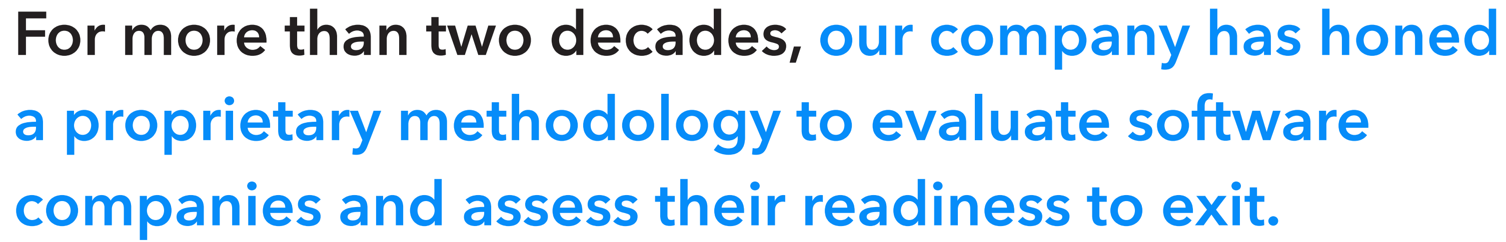
20 FACTORS

TO TRACK WHEN VALUING YOUR SOFTWARE BUSINESS

SEG | Software Equity Group



By considering critical aspects of the software industry, such as market demand, competitive positioning, financial performance, and more, we have not only achieved a leading first-pass success rate but consistently secured and often surpassed the valuation multiples our clients aspire to, guiding software operators to successful exits and garnering industry accolades along the way.

For years, we have shared our approach in this report. It serves as a benchmarking tool to clarify the complex metrics that buyers and investors use to evaluate software and SaaS companies and to help operators gauge their strengths and address areas for improvement. No single factor guarantees a high multiple, of course, but together, they provide a comprehensive overview of the qualities that buyers and investors find most compelling.

However, the market is ever evolving.

> **Key metrics like Gross Retention Rate and Profitability have shifted in significance. What remains crucial is software's indispensable role in operations, especially during economic downturns.**

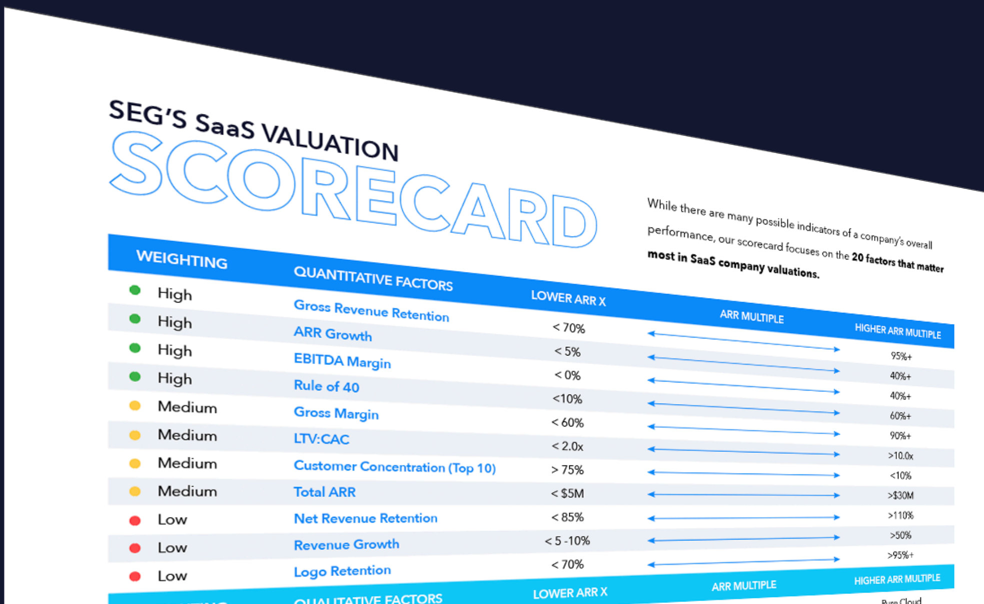
To stay apace with such shifts, we've refreshed this report. It's your window into the multifaceted determinants of a software company's valuation. Our goal is to help you maximize the value of your business.

The market will continue evolving, and the metrics buyers and investors prioritize will shift. One thing that won't change, however, is SEG's commitment to helping software operators adapt and stay ahead of emerging trends. We invite you to apply the lessons from this guide to your business, using them to make informed choices and seize opportunities in this dynamic environment.

SEG'S SaaS VALUATION SCORECARD

THE BREAKDOWN

Quantitative & Qualitative Factors



SEG'S SaaS VALUATION
SCORECARD

While there are many possible indicators of a company's overall performance, our scorecard focuses on the **20 factors that matter most in SaaS company valuations.**

WEIGHTING	QUANTITATIVE FACTORS	LOWER ARR X	ARR MULTIPLE	HIGHER ARR MULTIPLE
High	Gross Revenue Retention	< 70%	↔	95%+
High	ARR Growth	< 5%	↔	40%+
High	EBITDA Margin	< 0%	↔	40%+
High	Rule of 40	<10%	↔	60%+
Medium	Gross Margin	< 60%	↔	90%+
Medium	LTV:CAC	< 2.0x	↔	>10.0x
Medium	Customer Concentration (Top 10)	> 75%	↔	<10%
Medium	Total ARR	< $5M	↔	>$30M
Low	Net Revenue Retention	< 85%	↔	>110%
Low	Revenue Growth	< 5 -10%	↔	>50%
Low	Logo Retention	< 70%	↔	>95%+

QUALITATIVE FACTORS	LOWER ARR X	ARR MULTIPLE	HIGHER ARR MULTIPLE
			Pure Cloud

We divided the factors into two categories: quantitative and qualitative. For each factor, we give a definition, explain why it is important, and discuss how it impacts a company's valuation multiples.

Understanding where to improve is paramount. This whitepaper serves as an invaluable compass, guiding you toward the specific areas warranting attention. While ensuring that your data is correct and tracking in the right direction is vital, it is even more important to remember that valuation depends on context. No single metric should be taken as a guarantee of success or failure. Ultimately, your enterprise value will be based on a mixture of factors, including your product, your market, the overall economic climate, and the banker's competitive process.

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Low	Logo Retention	< 70%	←→	>95%+

WEIGHTING	QUALITATIVE FACTORS	LOWER ARR X	ARR MULTIPLE	HIGHER ARR MULTIPLE
High	Delivery Model	On-premise	Hybrid	Pure Cloud
High	Pricing Model	Non-Recurring	Transactional	Contracted Recurring
High	Product/Position	Commoditized	Differentiated	Highly Differentiated
High	Market Attractiveness	Pure Horizontal	Multi Vertical	Vertically-Focused
Medium	Technology	Legacy	Leading Edge	State-of-the-Art
Medium	Management Team	Less Experienced	Strong, Deep	Proven History
Low	Market Growth	< 0%	1-5%	>5%
Low	Total Addressable Market	< $100 Million	$100M - $1 Billion	$1 Billion+
Low	Assessment of Trends	Decelerating	Incremental	Accelerating

Quantitative metrics are the bedrock of empirical analysis, offering measurable and comparable figures. While these numeric values provide critical insights, it's essential to view them holistically, understanding that no single metric provides a complete narrative. The following factors are guidelines that provide a general idea of your quantitative strengths and weaknesses.

1) Gross Revenue Retention

Gross Revenue Retention (GRR) measures the percentage of recurring revenue retained from existing customers over time. It counts losses from customer churn or downgrades but doesn't include gains from new business or upgrades.

> **The highest possible GRR is 100%**

IMPORTANCE: A GRR acts as a reliable compass pointing toward revenue stability. A high GRR often signals a robust level of customer satisfaction and loyalty. Customers continue to find value in the product or service, leading to sustained revenues. Conversely, a low GRR could flag potential satisfaction, product fit, or service delivery issues.

IMPACT ON VALUATION: While previously net revenue retention (NRR) was a major focus, current market trends favor GRR. Investors and potential acquirers frequently associate high GRR figures with predictable future revenue. Companies with a high GRR can often command a higher valuation multiple. The rationale is straightforward: a software company that retains a sizable chunk of its revenue from its existing customer base will likely be more resilient against market fluctuations and strong forward revenue visibility.

Formula:

$$\frac{\text{Beginning ARR} - \text{Lost ARR} - \text{Contraction ARR}}{\text{Beginning ARR}}$$

Example:

Beginning ARR = $15,000,000

Lost ARR = $1,300,000

Contraction ARR = $1,000,000

$$\text{GRR} = \frac{\$15{,}000{,}000 - 1{,}300{,}000 - 1{,}000{,}000}{\$15{,}000{,}000} \times 100$$

$$\text{GRR} = 85\%$$

Explore the Pivotal Shift from Net Retention to Gross Retention.

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2) Annual Recurring Revenue Growth Rate

The Annual Recurring Revenue (ARR) growth rate calculates the percentage change in recurring revenue from yearly contracts and subscriptions, with a focus on consistent yearly revenue and excluding one-time payments.

IMPORTANCE: The ARR growth rate highlights your business's growth trajectory and future potential. It not only assures buyers and investors of the prevailing market demand, strong product-market fit, and unique product differentiation but also attests to your capability to capitalize on that demand. While a significant growth spike in a single year is promising, consistent growth over several years, as indicated by the Compound Annual Growth Rate (CAGR), is more telling.

IMPACT ON VALUATION: Simply put, the higher and more consistent the growth rate, the higher the multiple. **However, the days of growth at all costs are over.** Today, companies must balance this growth with efficiency and profitability (or, at the very least, a near-term path to achieving these metrics).

Formula:

$$\frac{\text{Current Year's ARR} - \text{Previous Year's ARR}}{\text{Previous Year's ARR}}$$

Example:

Current Year's ARR = $15,000,000

Previous Year's ARR = $11,000,000

$$\text{ARR Growth Rate} = \frac{\$15{,}000{,}000 - 11{,}000{,}000}{\$11{,}000{,}000} \times 100$$

$$\text{ARR Growth Rate} = 36\%$$

Dive Deeper into ARR with Our Top-Rated Blog Post –
a Favorite Among Our Readers!

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3) EBITDA Margin

EBITDA margin is your company's profit margin. The metric is defined as earnings before interest, tax, depreciation, and amortization (EBITDA) divided by total revenue and expressed as a percentage.

IMPORTANCE: EBITDA margin is a key financial metric that provides insights into the efficiency of the company's operations and the amount of cash flow generated by core activities. By stripping away factors that can vary greatly between companies, such as interest payments, tax strategies, and amortization, it reveals the underlying profitability of business operations and allows for apples-to-apples comparisons with other SaaS companies.

Like GRR, the EBITDA margin tells a more complete story when combined with other metrics. As discussed in the Rule of 40 section (see below), buyers and investors often consider it in the context of ARR growth to get a more complete picture of a company's overall financial health.

IMPACT ON VALUATION: EBITDA margin reflects a company's operational efficiency and ability to turn sales into profits. A stable or growing EBITDA margin implies consistent company performance, reducing investment risk. Regardless of market conditions, a company's ability to generate EBITDA margin in the near or long term is fundamental to valuation multiples.

Formula:

$$\frac{\text{Net Income + Interest + Taxes + Depreciation + Amortization}}{\text{Total Revenue}}$$

Example:

Net Income = $2,000,000
Interest = $50,000
Taxes = $200,000
Depreciation = $75,000
Amortization = $50,000
Total Revenue = $16,000,000

$$\text{EBITDA} = \frac{\$2{,}000{,}000 + 50{,}000 + 200{,}000 + 75{,}000 + 50{,}000}{\$16{,}000{,}000} \times 100$$

EBITDA = 15%

Master the Nuances of Calculating EBITDA for SaaS – Dive into Our Expertly Crafted Blog for all the Insights.

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4) Rule of 40

The Rule of 40 is a benchmark that combines a SaaS company's ARR growth rate with its EBITDA margin to assess overall financial health.

IMPORTANCE: For SaaS businesses, balancing growth and profitability can be challenging. Rapid growth often leads to higher costs, while a sole focus on profitability might stifle expansion. The Rule of 40 provides a holistic view, helping companies determine if their growth strategies are sustainable.

IMPACT ON VALUATION: A company achieving or surpassing the Rule of 40 can signal robust growth methods or efficient cost management, hinting at a company's long-term potential. This often attracts more attention from potential buyers or investors. It's essential to recognize that companies can achieve the Rule of 40 in numerous ways, such as:

- 0% ARR growth and 40% EBITDA margin = 40%
- 40% ARR growth and 0% EBITDA margin = 40%
- 20% ARR growth and 20% EBITDA margin = 40%

While the Rule of 40 is a useful guideline, some investors and buyers may be more drawn to companies exceeding this benchmark, sometimes looking for figures like 50, 60, or 70 when combining growth and profitability.

Formula:

ARR Growth Rate + EBITDA Margin

Example:

ARR Growth Rate = 36%
EBITDA Margin = 15%

Rule of 40 = 36% + 15% = 51%

Unlock the Power of the Rule of 40 in SaaS Businesses

and Gain More Insight into this Popular KPI.

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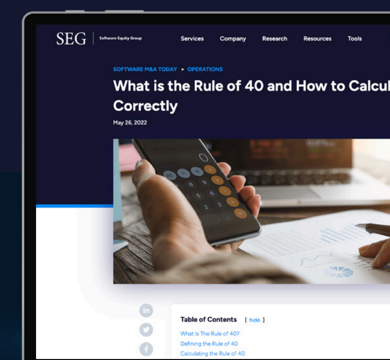

5) Gross Margin

Gross margin is the profit percentage after deducting direct costs (cost of goods sold or COGS) from total revenue. It reflects how efficiently a company turns sales into profits, considering expenses like hosting, support, and labor.

IMPORTANCE: Gross margins highlight the profitability efficiency of software companies, which often have high multiples due to their robust profit margins. A solid gross margin indicates more profits available for business reinvestment, making it a crucial measure of a company's financial health and long-term profitability.

IMPACT ON VALUATION: Gross margin is a valuable metric for potential investors and buyers. Those with margins above 75% are particularly enticing, signaling scalability and profit potential. Conversely, margins below 60% often suggest higher delivery and support costs, which can be a red flag for investors. Companies with high customer retention (GRR) but low gross margins might invest heavily in support or software implementation, impacting profitability. However, businesses that maintain both high GRR and high gross margin are extremely attractive to buyers, as they indicate rapid time to value, user-friendly products with minimal support needs, and strong value to a base of loyal customers.

Formula:

$$\frac{\text{Revenue} - \text{COGS}}{\text{Revenue}}$$

Example:

Revenue = $16,000,000

COGS = $3,000,000

$$\text{Gross Margin} = \frac{\$16{,}000{,}000 - 3{,}000{,}000}{\$16{,}000{,}000} \times 100$$

$$\text{Gross Margin} = 81\%$$

Dive In and Learn More About Gross Margin

and Why it's an Important Means for Evaluating Your Business' Growth Potential.

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6) LTV:CAC

LTV:CAC represents the relationship between a customer's Lifetime Value (LTV) and the Customer Acquisition Cost (CAC). LTV measures the total expected revenue from a customer over their relationship with the company, while CAC represents the cost to secure that customer.

IMPORTANCE: LTV:CAC is an important unit economic metric, encompassing several levers within the business, which speaks to the efficiency of the business model. By dissecting this formula, one can derive insights into essential components like ARR, Gross Retention, sales and marketing efficiency, and ROI. This metric indicates how efficiently a company's customer acquisition strategy affects its profitability. Ideally, the revenue a customer brings should exceed the cost to acquire them. A high ratio means the business is seeing a good return on its sales and marketing investments. Conversely, a low ratio suggests excessive spending on customer acquisition compared to the generated revenue.

Formula:

LTV:CAC Ratio = Lifetime Value ÷ Customer Acquisition Cost

LTV = (Average Customer ARR x Gross Profit Margin) ÷ Lost Attrition

Lost Attrition = Lost ARR during the period ÷ Beginning ARR

CAC = Total S&M spend for new customers ÷ Number of new customers

Example:

New Customer Count = 40

New S&M Expense = $2,000,000

Average Customer ARR = $35,000

Gross Profit Margin = 79%

Lost Attrition = 7%

LTV = $395,000

CAC = $50,000

$$\text{LTV:CAC} = \frac{\$395{,}000}{\$50{,}000} = 7.9\text{x}$$

Dive Deeper into the Calculations, Formulas, and Examples of LTV:CAC.

Learn More

IMPACT ON VALUATION: A robust LTV:CAC ratio suggests a company can scale its operations efficiently, making it more attractive to investors and buyers. A stable ratio over time indicates dependable customer acquisition and retention methods, reducing investment risk.

Niche businesses hyper-focused on addressing specific issues for a select audience often exhibit a unique advantage in this realm. By targeting a specific, underserved market segment, these businesses can achieve superior value propositions, driving loyalty and repeat business. As a result, they frequently boast excellent LTV:CAC ratios in the 8 to 10x range.

Well-performing broader market businesses typically land within the 5 to 8x range, which indicates a good balance between customer acquisition cost and the value they derive over time. Businesses with a ratio between 3 to 5x are considered average, often grappling with more competitive landscapes and less differentiated offerings.

Along with the many benefits a good ratio can have for your business, it also provides a great health check for CEOs planning for future M&A processes. Ultimately, knowing how to calculate LTV:CAC is an important skill for SaaS leaders and can provide valuable insight into a company's financial performance."

- Allen Cinzori, SEG

7) Customer Concentration

Client concentration measures the percentage of revenue coming from a single customer. High concentration means a lot of revenue depends on a few customers. Low concentration means revenue is spread out among many customers.

IMPORTANCE: Too much revenue from one customer can be perceived as a risk to potential buyers or investors. If that customer leaves, it could disproportionately impact the company's revenues and profitability.

IMPACT ON VALUATION: Companies where revenue is heavily concentrated among a few customers can be seen as riskier, potentially diminishing their value. On the other hand, if revenue is spread out among many clients, the company is seen as more stable and valuable. As such, software companies demonstrating a diversified customer base and lower customer concentration may command higher multiples due to their reduced risk profile and increased stability. However, exceptions arise when top clients hold long contracts, display remarkable retention, or have significantly increased ARR within the account – all indicators of a robust partnership and a minimal likelihood of termination.

Customer Concentration

Example:

In this example, if the software company's ARR was $15M, then its **customer concentration would be 13%**, as the top 10 customers total $1,950,000 of ARR.

Top 10 Customers	ARR	% of Total
1	$255,000	1.70%
2	$240,000	1.60%
3	$225,000	1.50%
4	$210,000	1.40%
5	$180,000	1.20%
6	$165,000	1.10%
7	$165,000	1.10%
8	$165,000	1.10%
9	$150,000	1.00%
10	$150,000	1.00%
Total	**$1,950,000**	**13.00%**

8) Total ARR

Total annual recurring revenue (ARR) is the yearly revenue from software subscriptions, often called the annualized version of monthly recurring revenue (MRR).

IMPORTANCE: ARR indicates the yearly recurring revenue a company expects, making it a key signal of its overall health and growth potential. Buyers and investors pay close attention to this metric, especially for software companies in the lower-middle market segment.

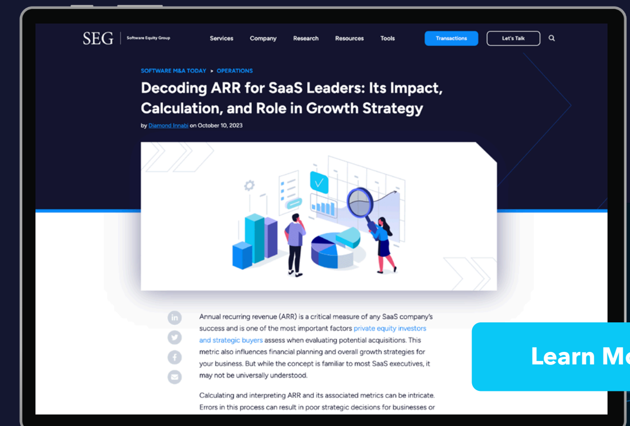
IMPACT ON VALUATION: Size matters in valuation multiples. A larger ARR isn't just an indicator of a company's success but amplifies its value due to a multiplier effect on the valuation multiple. Generally, there's a multiple premium for scale. As a result, a company with a 40M ARR will likely command a more favorable multiple than a similar entity at 20M ARR. The reason behind this is twofold. First, a substantial ARR provides concrete evidence that the business model is validated and sustainable over the long term. Second, as ARR grows, there's a richer history to underscore the business' success, resilience, and scalability potential.

Formula:

MRR (Monthly Recurring Revenue) × **12** at any given point in time

Decoding ARR for SaaS Leaders:

Its Impact, Calculation, and Role in Growth Strategy



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9) Net Revenue Retention

Net Revenue Retention (NRR), often referred to as Net Dollar Retention (NDR), gauges the change in annual recurring revenue (ARR) from existing customers over a specified period without accounting for new sales. This metric considers ARR expansion from upsells and subtracts ARR contractions and losses from customer churn.

IMPORTANCE: NRR offers a glimpse into customer satisfaction, how well the product fits the market, and the company's skill in boosting ARR from current customers. A high NRR suggests growing revenue from the existing customer base, indicating strong loyalty, effective upsell strategies, and a product that consistently meets user needs.

IMPACT ON VALUATION: A robust NRR highlights a company's ability to optimize its current customer relationships to increase ARR, a strategy that's often more cost-efficient than getting new clients. NRR above 110% is an excellent sign, indicating scalable, predictable growth, which attracts buyers and investors. However, NRR below 100% for businesses with strong account management may signal ARR retention issues.

Formula:

$$\frac{\text{(Beginning ARR + Expansion ARR – Lost ARR – Contraction ARR)}}{\text{Beginning ARR}}$$

Example:

Beginning ARR = $15,000,000
Expansion ARR = $2,500,000
Lost ARR = $2,000,000
Contraction ARR = $1,000,000

$$\text{NRR} = \frac{\text{(\$15,000,000 + 2,500,000 – 2,000,000 – 1,000,000) 200,000}}{\text{\$16,000,000}} \times 100$$

NRR = 97%

Learn More About the Pivotal Shift from **Net Revenue Retention to Gross Revenue Retention.**

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10) Revenue Growth

Revenue Growth measures how much a company's total revenue has increased over a set period, often year-over-year. Unlike ARR growth, which focuses solely on the health of recurring revenues, Revenue Growth aggregates all revenue sources, including recurring subscriptions, one-time sales, implementation services, licensing fees, and more. This broader perspective offers insights into various revenue streams and can be influenced by different revenue recognition policies.

IMPORTANCE: Revenue Growth offers an encompassing perspective on a company's fiscal health, extending beyond the insights provided by ARR growth, which we've recognized as a significant metric with our "High" weightage. This insight lets us discern exactly what is propelling the company's growth. For buyers and investors, growth primarily driven by ARR is often more attractive for the reasons we stated previously.

IMPACT ON VALUATION: Robust revenue growth, underpinned by a strong ARR, often translates to a higher valuation multiple. This is attributed to buyers' preference for businesses with steady and predictable revenue streams, which signify reduced risks and promise a more reliable return on investment. Conversely, if the growth rate is buoyed primarily by transient revenue sources, it might lead to a more conservative multiple.

Formula:

$$\frac{\text{(Current year total revenue – Prior year total revenue)}}{\text{Prior year total revenue}}$$

Year	Total Revenue	Growth Rate
2020	$3,000,000	
2021	$4,800,000	60%
2022	$7,800,000	63%
2023	$12,000,000	54%
2024	$18,000,000	50%

Watch This Discussion with

SEG Managing Partner Allen Cinzori and Tim McCormick, Former CEO of SaaSOptics (now Maxio) to Learn More About Revenue Growth.

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11) Logo Retention

Logo Retention, sometimes called Customer Retention, measures the percentage of customers (logos) a company retains over a certain period, typically a year. It indicates how successful a company is at avoiding customer churn.

IMPORTANCE: Logo retention provides insight into a company's customer satisfaction levels, the effectiveness of its customer retention strategies, and the overall stickiness of its products and services. A high rate suggests that a company has a durable customer base and demonstrates that customers find value in the company's offerings. It also implies that your company's customer relationship management efforts are effective and capable of building long-lasting ties. As such, this reflects positively on your brand reputation and market position, which can, in turn, help attract new customers, enhance market share, and positively impact the company's enterprise value.

Formula:

$$\frac{\text{Total Customers (beginning of period)} - \text{Lost Customers (in that period)}}{\text{Total Customers (beginning of period)}}$$

Example:

Total Customers on 1/1/23 = 800

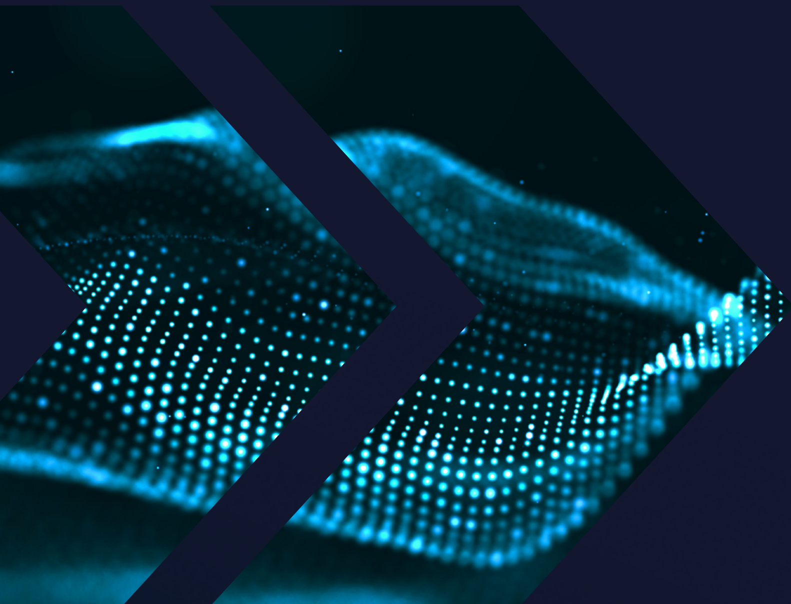
Lost Customers in 2023 = 25

$$\text{Logo Retention} = \frac{(800 - 25)}{800} \times 100 = 97\%$$

IMPACT ON VALUATION: But while logo retention is essential, it does not tell a complete story. For instance, a company might flaunt a strong logo retention of 95%, but if the departing 5% of customers comprises its most substantial ARR contributors, the repercussions on gross and net revenue retention can be significant. Moreover, if a dip in logo retention predominantly concerns smaller customers while still maintaining a strong GRR or NRR, it could still present a favorable financial outlook. Ultimately, it's the revenue – or the dollars – that holds paramount significance in valuation. This underscores the point that while logo retention is a meaningful metric, the financial ramifications associated with customer churn – specifically, which customers are churning – carry weightier importance in determining valuation multiples.

The focus on gross retention as a key metric underscores the importance of long-term stability and minimizing churn, but without understanding logo retention, the story is incomplete. Logo retention provides visibility into the concentration and segmentation of lost customers, answering many important questions."

- Brad Weekes, SEG



DELVING INTO QUALITATIVE FACTORS IN SaaS COMPANIES

While numerical metrics are integral to a company's enterprise value, it's equally vital to factor in qualitative elements that sketch out the broader market stance and growth trajectory for a software firm. Such elements extend beyond the fiscal data, capturing the firm's operational blueprints, competitive edge, and potential for long-term triumph. To truly gauge a software company's worth, one must be versed in these eight pivotal qualitative facets. Comprehending these factors equips software practitioners with the strategic knowledge required to align decisions with their overarching goals.

See the Qualitative Factors

12) **Delivery Model**

A delivery model is a method used to provide software applications to customers, including all-cloud, on-premise, and hybrid models.

IMPORTANCE: The delivery model is the core of the business, shaping how customers interact with products and services, how updates are deployed, and how costs are structured. It dictates user experience, rollout strategies for updates, cost dynamics, and, crucially, the scalability of the software's architecture.

IMPACT ON VALUATION: On a relative basis, a pure cloud, multi-tenant, state-of-the-art architecture will generally garner a higher multiple versus an on-premise offering that has more technology debt or legacy elements.

- An **all-cloud model** provides advantages in scalability, cost-effectiveness, and ease of updates, as it can be accessed anywhere with an internet connection, and updates can be rolled out simultaneously to all users.

- **Traditional on-premise** solutions, though still relevant in certain industries, are often associated with higher implementation costs and longer time-to-value. However, they continue to appeal to enterprises with specific infrastructure and data handling requirements.

- **Hybrid delivery models**, a blend of cloud and on-premise solutions, offer flexibility to cater to a wider array of customer preferences. This approach allows companies to tailor their software offerings to suit individual client needs, addressing data privacy, security, and regulatory compliance concerns. While hybrid models may not match the cost-effectiveness of delivery solutions, they provide a bridge for companies hesitant to embrace the cloud fully.

13) **Pricing Model**

A pricing model is how a company charges customers for their products and/or services. It's the framework that determines how revenue is generated, whether it's a one-time fee, a recurring subscription, or a fee based on special transactions.

IMPORTANCE: The pricing model is vital because it directly impacts revenue visibility, which is the ability to predict and anticipate future revenue streams. A clear understanding of future revenue is essential for planning, scaling operations, and making informed business decisions. Stable and predictable revenue is particularly attractive to stakeholders as it minimizes uncertainty and risk.

IMPACT ON VALUATION: Pricing models significantly influence a company's revenue predictability and, by extension, the multiple a company can achieve when pursuing sale or investment. Moreover, they deeply impact the customer lifetime value, a critical measure of long-term profitability and growth potential. As we delve into the Contractual Recurring, Transactional Recurring, Non-Recurring, and Usage-Based pricing models, we uncover the nuanced ways each model shapes the perceived value and sustainability of a software company in the eyes of a stakeholder.

- **Contractual Recurring:** This is a subscription-based model where customers commit to paying a regular, fixed amount, typically monthly or annually. Given its predictability, this model offers the highest revenue visibility. Companies with a high proportion of contractual recurring revenue often achieve higher multiples because of the certainty and sustainability of their revenue streams.
- **Transactional Recurring:** Under this model, companies charge customers based on specific transactions, such as payment transactions. Although it offers recurring revenue, it's less predictable than the contractual model due to fluctuating transactions. While the valuation multiple might be affected by this variability, the potential for significant annual expansion within a transactional model can enhance its value.
- **Usage-Based:** This model charges customers based on their actual usage of a product or service, like cloud computing resources or API calls. It offers flexibility to customers and can scale revenue with customer growth. While revenue can be recurring, it might not be as predictable as the contractual recurring model, especially if usage patterns fluctuate. However, with the rise of cloud services and the increasing preference for "pay-as-you-use" models, companies with significant usage-based revenues can achieve attractive multiples, especially if they demonstrate consistent user growth and engagement.
- **Non-Recurring:** Here, customers pay a one-time fee for a product or service without any future payment commitment. This model offers the least revenue visibility since there's no guarantee of future revenue without acquiring new customers continually. Companies relying heavily on non-recurring revenue may receive lower multiples, given the unpredictability and the constant need for customer acquisition.

14) Product & Position

Product *is the software applications, services, or solutions provided, addressing user challenges with unique features and benefits.* ***Market position*** *reflects how the offering is perceived and valued in comparison to competitors.*

IMPORTANCE: Product differentiation is the key to highly valued software businesses. Differentiated products usually lead to strong customer retention, significant growth, and increased customer loyalty. In contrast, commoditized products struggle to compete and face higher churn rates. Product differentiation can be achieved through usability, product depth and breadth, vertically focused or purpose-built solutions, and so on. Differentiated products aren't easily duplicated overnight, which is important to buyers and investors.

Market position is about establishing a distinctive place in the market, achieved through a differentiated product, product quality, branding, customer service, and marketing strategies. Small to mid-size software companies can succeed by continuously improving market share and demonstrating superiority over competitors.

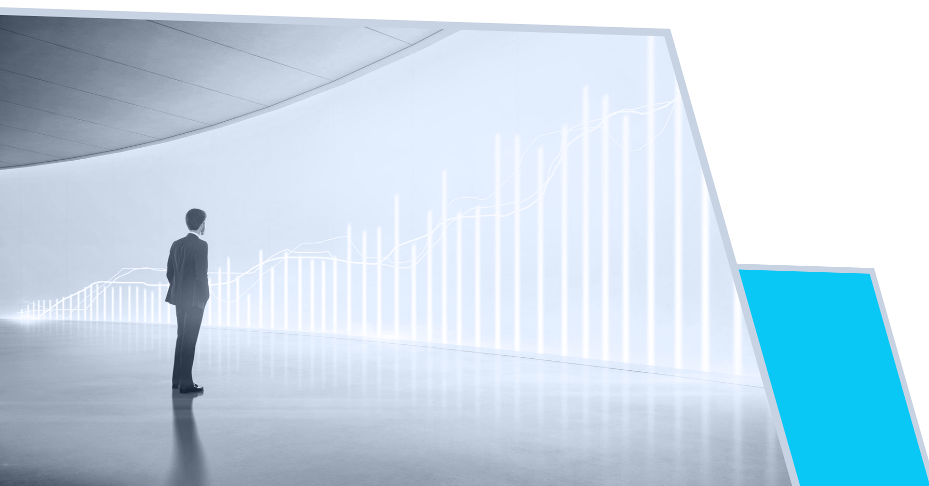
IMPACT ON VALUATION: A company that consistently innovates and establishes a distinct product niche differentiates itself in a saturated market, enhancing valuation multiples. In tandem, a business that solidifies and perpetually elevates its market position, outpacing competitors, significantly boosts its valuation as well.

15) Market Attractiveness

Market attractiveness gauges the potential opportunity of a market segment for a company, considering factors like its size, growth rate, and competitive landscape.

IMPORTANCE: Market attractiveness is crucial as it delineates the opportunities and limitations of a company and its offerings. In expansive, growing, and less congested markets, a company's value is particularly enhanced when it occupies a unique position. Market attractiveness is shaped by elements such as growth potential, long-term profitability, product relevancy, and the ability to adapt to changing consumer behaviors. Recognizing these factors informs potential buyers about a company's growth trajectory and responsiveness to market shifts.

IMPACT ON VALUATION: Insight into market attractiveness allows buyers and investors to assess a company's potential more effectively for sustained success. Thriving markets signal opportunities for rapid growth, which could increase valuation multiples; particularly, a market undergoing a significant inflection point, driving adoption for new software can drive multiples up. It's not always critical for a market to be large and rapidly growing for it to be attractive. Many times, smaller niche markets can also be highly attractive. This is especially true if the competitive density is low, the company has sufficient runway to grow for the foreseeable future, and has a strong market position with a differentiated product.



16) **Technology**

Technology is the set of frameworks, libraries, software languages, and infrastructure used to develop and launch a software platform.

IMPORTANCE: The technology behind a software product directly influences the product's performance and user experience. A well-designed and efficient tech stack demonstrates a company's ability to scale its operations seamlessly and accommodate a growing customer base without compromising performance.

Moreover, the technological capabilities of a software platform directly impact its competitive edge in the market. Innovative technology, novel frameworks, and cutting-edge libraries allow a product to scale better and provide a platform that allows for more rapid innovation.

IMPACT ON VALUATION: When buyers and investors evaluate a software company for potential acquisition or investment, they delve into several specific technological aspects to determine its valuation multiples.

At the forefront of their assessment lies **scalability**; they want to ensure the technology can handle surging growth in users, transactions, or data without requiring substantial overhauls. A platform that can effortlessly scale promises future expansion opportunities at minimal additional costs. In an era where cyber threats are escalating, **security** becomes paramount. Investors will gauge the robustness of security measures in place, with any past vulnerabilities or breaches being potential red flags that could reduce the multiple.

The **modularity** and **maintainability** of software are vital, with systems requiring effortless updates while enabling rapid innovation are both highly valued. **Interoperability**, enabling seamless integration with diverse platforms, is crucial in our interconnected tech world. Together, these factors influence a software company's valuation multiples.

17) Management Team

The management team is the group of executives responsible for overseeing and leading the company's operations, strategies, and decision-making process.

IMPORTANCE: The management team is pivotal in guiding a software company's trajectory and success. Buyers and investors prioritize leadership with a track record of executing business plans and possessing a forward-thinking vision. Beyond product and financials, the team's past successes suggest future potential, elevating valuation. With stable leadership, succession planning, and a positive culture, the company's value in the eyes of stakeholders rises. While these qualities are beneficial, they aren't all mandatory for a company to be seen as valuable.

IMPACT ON VALUATION: The management team's collective capabilities can sway valuation. Investors and buyers recognize that while software code, intellectual property (IP), and customer contracts have intrinsic value, it's the human element – the leadership team – that knits these assets together, guiding the company to success. As such, strong, experienced, and visionary leadership can command a higher valuation multiple, reflecting the reduced risk and increased potential for sustained growth and profitability. Conversely, gaps in leadership represent potential risks as functional groups without solid leadership often have deficiencies in operations that could inhibit the business going forward. Most smaller companies do have gaps in the management team. Buyers and investors can often live with gaps in sales and marketing, as they often bring value to the table. At the same time, gaps in product and technical leadership can have a significant impact on valuation, as it is reflected in the quality of the architecture and differentiation of the product.

18) Market Growth

Market growth is the change in the size, demand, and opportunities of a particular market over a period. It is typically represented as the percentage change in the total sales (in terms of units or revenue) of all companies in the market.

Market growth can be influenced by changes in customer needs and preferences, population growth, technological advancements, economic conditions, and other factors.

IMPORTANCE: Expanding markets hint at increased adoption, making it potentially easier for businesses to make sales. Even in situations where the market might not be expanding significantly, there can still be robust growth opportunities. If the Total Addressable Market (which we will discuss next) is sizable and a company's solution offers substantial value, it can thrive. This is often the case with many of our clients who are displacing legacy technology or automating manual processes. Their strong value propositions provide solid growth prospects despite rapid market growth. Awareness of market growth rates facilitates goal setting for companies and enlightens potential buyers and investors about the prospective sales momentum.

IMPACT ON VALUATION: A burgeoning market not only signals greater revenue potential due to an expanding customer base but also implies reduced business risks, as companies can grow simply by maintaining their market share. Such dynamics naturally attract investors, thereby enhancing valuation multiples. Furthermore, a software company's prominent position in a rapidly growing market magnifies its appeal, as it suggests the potential to capture a significant slice of that growth. This, combined with future profitability and strategic opportunities like mergers and acquisitions, underscores the profound impact of market growth on valuation metrics.

19) Total Addressable Market (TAM)

Total addressable market (TAM) is the overall revenue opportunity available to a product or service, assuming a 100% market share.

It represents the upper limit of the market size—essentially, the maximum annual revenue a business could generate if it dominates its product or service category.

IMPORTANCE: A substantial TAM indicates vast growth and profit potential, but it's crucial that the company can effectively tap into revenue from this market. Conversely, a smaller TAM might suggest a niche, potentially limiting long-term growth. For SaaS companies that have chosen not to raise a substantial amount of money through venture capital, it's essential for a company's TAM to be expansive enough for growth yet not so vast that it becomes a magnet for intense competition, which could hamper its ability to maintain or even capture market share. The ideal TAM is a balance: large enough for substantial growth potential while maintaining your strong differentiation but not so immense that it becomes a competitive battleground.

IMPACT ON VALUATION: It's worth noting that a smaller TAM doesn't inherently limit a company's value. A business operating within a small TAM but with potential for lateral expansion can be highly appealing. On the other hand, a small business with an enormous TAM might grapple with differentiation challenges due to heightened competition. Ultimately, while TAM size is a factor, companies must weigh it against their competitive strengths and resources to ensure their market position remains both lucrative and sustainable.

20) **Assessment of Trends**

Assessment of Trends is the analysis and evaluation of patterns, shifts, and emerging factors to identify and understand their implications and potential impact on the present and future.

IMPORTANCE: By examining the direction of KPIs, potential acquirers can ascertain whether the business is progressing favorably or veering off course. While the current metric might not represent an ideal picture, a positive trend signifies potential. An upward trend can be leveraged to paint a compelling narrative of a promising future, which is particularly vital for attracting buyers and investors. Even if today's numbers aren't optimal, a trajectory pointing in the right direction can bolster confidence, enabling stakeholders to envision and advocate for the business's long-term potential. Similarly, from a market standpoint, if the market is undergoing a significant inflection point and driving demand for new innovative solutions, a company offering such solutions can have a positive impact on value.

IMPACT ON VALUATION: From a valuation multiple perspective, these trends play a crucial role. Buyers and investors typically formulate models projecting a company's performance over extended periods, often spanning 5 to 10 years. The assumptions made in these models regarding key KPIs are significantly influenced by existing trends. A positive trend makes it easier for investors to anticipate future metrics that surpass current ones, thus elevating the company's perceived value. Conversely, downward or negative trends can cast a shadow on projections, potentially leading to diminished multiples. Essentially, the direction of business trends can either enhance or erode the value attributed to a company in the eyes of potential buyers and investors.

Don't Look Through the Windshield Before Checking Your Rearview Mirror

While the gaze of software founders and CEOs naturally shifts towards the horizon, it's crucial to appreciate the journey traveled thus far. The allure of future innovation shouldn't overshadow the foundation laid in the past.

Strategic buyers and discerning investors weigh past achievements as reliable predictors of future success. This track record not only vouches for your company's robust foundation and unique selling propositions but also indicates its indispensable value to customers.

Allen Cinzori, Managing Director at SEG, aptly points out, "In the realms of M&A and private equity recapitalizations, the emphasis is less on speculative future promises and more on tangible historical accomplishments. The approach contrasts with venture capital, which bets heavily on future potential."

Investments in product development and novel platforms demand returns. Without demonstrable outcomes in sales and retention, expecting premium multiples might be premature. The past milestones hold the key to convincing buyers of your worth. Once the historical performance validates your claims, only then will they entertain future projections.

This white paper's 20 factors act as a comprehensive retrospective, helping you discern both your accomplishments and areas of improvement. By addressing these facets, you can bolster your strengths and rectify shortcomings, ensuring your company's enterprise value reflects its true worth.

Allen Cinzori & Brad Weekes
Managing Directors

SEG | Software Equity Group

Our Team of Experienced M&A Advisors Understands Value Drivers

The team at SEG can provide insight into making your company more attractive long before you are ready for a liquidity event. Then, we will work to bring the best parties to the table, handle negotiations, and manage due diligence so you can achieve the best possible outcome.

Talk to us about your 20 factors and learn what your software company valuation is today.

CONTACT US