APRIL 2021
www.bdo.com/technology

INSIGHTS FROM THE BDO TECHNOLOGY PRACTICE

THE M&A METRICS SOFTWARE COMPANIES NEED TO KNOW

Software companies may be surprised by the metrics used to gauge their value and growth potential during M&A. Knowing what investors look at is core to the deal negotiation process.

Over the past few years, U.S. private equity (PE) interest and investment volume in the technology industry has risen steadily. Major generalist PE funds like Blackstone, Carlyle and KKR are increasingly focused on the technology industry, allocating 20-30% of their assets under management to that sector. The technology specialist PE funds have been the most successful fundraisers, as Silver Lake Partners Fund VI and Thoma Bravo's Fund XIV were the two largest North American private equity funds closed in 2020, each with approximately $18 billion of funding. In terms of success among the technology specialists, Francisco Partners was ranked as the #1 performing PE fund in the 2020 HEC-Dow Jones, unseating the previous #1, Thoma Bravo.

When the COVID crisis hit, the deal pipeline slowed as companies and investors alike braced for impact and waited for the dust to settle. However, even amid widespread market volatility over the past 12 months, the appetite for tech deals—and software in particular—has remained incredibly strong.

Some major deals from the past year stand out. Early in the crisis, Koch Industries acquired Infor for a rumored $13 billion. Then, in mid-December, Thoma Bravo acquired RealPage at a value of approximately $10.2 billion, including net debt. Recently, Okta announced it would acquire Auth0 for $6.5 billion. Technology deals comprised 31% of global private equity and venture capital deals in 2020, more than twice as much as the next largest industry sector. These came alongside an array of major software IPOs, including Roblox, Snowflake, Qualtrics, AirBnB, Wish and more.

The increasing popularity of software, and SaaS in particular, can be traced back to the industry's adoption of a subscription-based model, which provides a steady and reliable flow of revenue. When COVID-19 hit, this became even more important to potential investors—the ability to track a steady flow of cash coming in and the potential for ongoing growth was key to successful portfolio projections amid other areas of financial uncertainty.

As we look ahead to the coming year, opportunities to raise outside capital are abundant for software companies, with PE and VC funds, in particular, stocked with significant dry powder. With 2021 set to be a potentially record-breaking year for PE-SaaS deal value and volume, software companies must ensure they are aware of what investors are looking for before they enter any sort of deal negotiation.

WHAT ARE THE VALUATION DRIVERS?

During 2020 and 2021, software company valuations have reached all-time highs, despite the major headwinds that other sectors have experienced due to COVID-19. What is behind that phenomenon?

As financial market pressure rose during COVID-19, the Federal Reserve responded with monetary policy levers, reducing interest rates and maintaining those low levels. Generally, lower interest rates increase underlying valuation multiples, but those valuation multiples must be applied to a company's operating performance. Revenue and profit growth also drive valuation multiples higher, while revenue and profit declines drive valuation multiples lower. Software is one of the few sectors that has been able to generate revenue and profit growth during the pandemic, which—combined with the higher valuation multiples resulting from the Fed's aggressive monetary policy—has driven software valuations to all-time highs, which contrasts with difficulties experienced in other sectors.

Private equity and venture capital investors, however, have different perspectives on the relative importance of different valuation metrics. Venture capital investors focus primarily on revenue multiples and future growth prospects, including market size and products/intellectual property, given that they are investing in immature companies. Private equity investors focus on revenue and EBITDA multiples, cost synergies and growth prospects, including the potential to leverage add-on acquisitions. A common theme for both PE and VCs is the importance of revenue metrics.

ANNUAL RECURRING REVENUE (ARR)

ARR and monthly recurring revenue (MRR) are presently considered the most important metrics for software and SaaS companies. ARR and MRR are generally calculated by aggregating the total daily contracted revenue as of a specific point in time and either annualizing it, in the case of ARR, or converting to monthly for MRR. MRR is used for companies that are oriented towards month-to-month or monthly invoiced contracts.

ARR is often seen as an indicator of the predictability of revenues for a software company. Companies with higher ARR are able to be more precise in their revenue forecasts and to achieve those forecasts, which is attractive to investors. Since ARR annualizes contracted revenues at a given point, it is also often interpreted as a real-time indicator of a company's revenue growth as compared to GAAP revenues, which for SaaS or subscriptions can lag the actual contracted bookings.

In COVID-19 times, ARR has become even more important, as it is seen as an indicator of the reliability of a company's software solutions and revenue stream. The software industry has seen renewal rates increase during the pandemic, while new deal bookings have generally been softer. Most companies have been hesitant to reduce spending on IT infrastructure and security and on resources to facilitate remote working, thereby continuing to renew existing technology investments. However, depending on the sector and despite the acceleration of digital transformation, we have seen some companies pull back on new capital expenditures due to the uncertainty of COVID-19. Therefore, the predictability of ARR and subscription revenues yields much higher valuation multiples versus perceived one-time revenues from on-premise licenses or usage-based charges.

ARR is particularly important to PE investors as banks are often willing to lend more based on the predictability of revenues. If a PE firm is able to borrow 75% of the purchase price of a software company, they will likely be willing to pay a higher valuation than if they were only able to borrow 40% of the purchase price. Therefore, revenue predictability and robust ARR translates directly to higher exit valuations.

TRANSITIONING TO ARR

Given the importance of ARR, many companies who have lumpy revenues resulting from on-premise solutions or usage-based fees continue to look for ways to transition to higher ARR or contracted revenues. In the case of on-premise solutions, the advent of the new GAAP **revenue standards** required most on-premise term licenses to be recognized upfront, rather than ratably. Generally, that lack of ratably recognized contracted revenue translated to a lower ARR metric. Many of these on-premise software companies have explored means of maintaining ratable revenue recognition, such as developing hybrid on-premise/cloud solutions, providing customers with termination for convenience rights or transitioning their solutions from a monolithic architecture to a microservices architecture to meet customers' need for increasing flexibility and scalability.

Companies with cloud-based solutions that charge usage-based fees often experience revenue fluctuations that are dependent on customer usage. While customers often prefer having a variable cost structure, many SaaS and software companies attempt to improve revenue predictability by increasing the minimum volumes and fees, thereby reducing the volume-based revenue component. Normally these pricing structures involve lower per unit rates for minimum volumes and higher per unit rates for any excess volumes. One strategy that SaaS and software companies employ is to use the excess volumes as an opportunity to engage with the customer to upsell to a higher recurring minimum volume or fee, and to waive the expensive overage charges in the event that the customer is willing to increase recurring minimum volumes/fees. If successful, this has the impact of increasing ARR, given the increase in baseline revenues.

GROWTH AND REVENUE COMPOSITION

Revenue growth rates are an important metric for both PE and VC funds. While VC funds are often focused primarily on high revenue growth, PE funds generally target a combination of revenue and EBITDA growth. PE investors often set a goal for their portfolio companies to achieve "the Rule of 40". In the Rule of 40, a company's EBITDA margin percentage plus their revenue growth percentage should equal 40%. Often, a key element of PE funds growth strategies for their portfolio companies is growth through acquisitions.

Composition of revenues is also an important consideration to investors. The key considerations in terms of revenue composition are often:

- **Customer concentration:** If revenues are concentrated among a small number of customers, the impact of the loss of a key customer is much greater—and often, those key customers have significant pricing and channel leverage over the software company.
- **Industry concentration:** During COVID-19, industry concentration has been increasingly important as software companies with focuses in the travel, hospitality/restaurants and energy sectors have been greatly impacted. Alternatively, customers with a broad industry base have not been significantly impacted.
- **Existing vs. new customers:** It can be important to demonstrate that revenue growth is generated by both recurring customer renewals and upsells and new customer logos. While new customer growth is not necessarily more important to demonstrate than recurring customer growth (and vice-versa), it will be important for investors to understand this composition as it will significantly influence future go-to-market strategies and resource investments. Further, if the PE fund views the software company investment as part of a roll-up strategy, they will be looking for synergies from leveraging the existing customer base.

RENEWAL AND RETENTION RATES

The primary metrics in measuring existing customer revenues are renewal or retention rates. High renewal rates indicate that a software solution is sticky, and that one or both of the following applies: customer satisfaction levels are high, or the solution is mission critical to an organization and difficult to switch out. The traditional metric for SaaS and software has been the customer retention rate, which is generally a straight measure of the percent of customers that recur each year, either through renewals or through multi-year contracts. However, this metric does not capture customer upsells or scope reductions, and therefore has limitations.

Dollar-based retention rates are in many ways similar in scope to renewal rates. They measure how customers expand their purchases from your company over a given time by investing in product upsells or expanding their user base or number of solutions purchased, net of customers reducing their scope of usage.

Investors will often look at the relationship between different, related metrics. The most relevant retention/churn type of metrics are:

- Customer retention rate: this is based on customer numbers. The downside is that this does not capture customer upsells or scope reductions.
- Customer churn: the inverse of customer retention rate.
- Net retention rates (dollar-based): this takes the year over year (generally recurring/contractual) revenue for existing customers compared to those same customers one year prior. This captures upsells and downsells.
- ARR from new customers: This is often useful as a complement to net retention rates to show the composition of revenues from new versus existing or retained customers.

GROWTH RATES

When examining growth rates, investors will look at details about where growth comes from and how stable it is over time. PE firms often look at more mature companies and will be more comfortable with lower growth rates than VCs if there is provable, stable growth over time. This is often referred to as the average annual growth rate (AAGR).

Growth rates apply across many different parts of your operations, including profits, cash flow, expenses, etc. PEs' main focus tends to be revenue and profit growth. It is worth noting that you will generally be expected to show double-digit growth, as this is a general trend across much of the software industry. For example, Salesforce, the largest SaaS company with over $14 billion annual revenue, saw almost 30% year-on-year growth **in the second quarter of 2020**. That was before adding Slack through the recent acquisition, which could help increase revenue growth even further.

Other areas that affect the growth evaluation include growth from new customers vs. existing customers and revenue growth by product or service line items.

SALES AND MARKETING METRICS

Your growth and revenue rates are often linked to your marketing and sales efforts. High marketing spend often equals sales growth. However, high marketing spend can also hamper your growth rates and future potential for profitability, not to mention influence your burn rate.

PEs will look at how your marketing and sales efforts are distributed, including specific industry or sales channel prioritization. While it may vary, data analysis shows that certain combinations of channels and spend vs revenues often lead to the best results. If you are far from the median values, investors will want to understand your strategic reasoning.

Other core metrics include sales cycle length and time spent in a specific sales stage. This metric regards how long it takes for a new, potential customer to move through the sales pipeline to a closed deal. The metric can help identify bottlenecks and enable management of deal slippage. The latter covers the number of customer committals that fail to close within a forecasted period. Assuming that your CRM data is accurate, sales cycle analysis and deal slippage can enable you to predict future bookings and diagnose issues with your sales process or team.

CUSTOMERS AND CUSTOMER ACQUISITION COSTS (CAC)

Examining customers, their situation, and prospects necessitates detailed data covering many different vectors. From this foundation, you have a platform for telling a metrics-driven story about how you have built your customer base, their value, and future potential of existing and prospective customers to entice investors.

One of the core metrics is customer acquisition cost (CAC). Often it is described as your total marketing and sales expenses for a period divided by the number of customers acquired during that same period. That can be compared to your lifetime customer value to evaluate ROI on your sales and marketing investment.

CAC will vary over time. At the start-up stage, it will likely be high. Investors will want to see decreasing CAC over time, as it indicates that you are gaining market traction.

Target customer groups and how you have succeeded in engaging them will also be central. This metric shows your ability to grow specific customer segments and increase revenue through targeted efforts. As previously mentioned, your customer concentration, industry focus and new versus recurring customer mix are also of interest to investors.

OTHER CENTRAL INVESTMENT METRICS

At the end of negotiations, you get to sign on the dotted line and will have new capital injected for your growth plans. The exact amount of capital injected often depends on the metrics described above. Other metrics and other parts of your company also play a big role. The same goes for avenues of growth, capital expenditure requirements, debt and tax structure, to mention just a few areas.

For younger software companies, one of the core metrics will be your burn rate. This is by far the most critical KPI metric to track internally for start-ups and scale-ups. The burn rate is the amount of cash spend per month that exceeds your monthly revenue divided into the amount of capital you have available. So, if you have capital reserves of $1 million and a burn rate of $100,000, you have ten months left to either improve performance, raise additional capital, or risk going out of business.

Gross margin and R&D as a percentage of revenue are other metrics that PE firms will look at during deal prospectus. The same may apply to the cost of revenue, which can be measured in many ways.

In all cases, consulting with advisors can help inform you of what metrics and calculation methods a potential PE investor will pursue and how you can get the optimal result of deal negotiations.

CONTACT:

DOUG HART
Assurance Partner
Technology Practice Leader
415-490-3314 / dhart@bdo.com

AFTAB JAMIL
Assurance Partner
Technology Practice Leader
408-352-1999 / ajamil@bdo.com

ABOUT THE TECHNOLOGY PRACTICE AT BDO USA, LLP

BDO has been a valued business advisor to technology companies for over 100 years. The firm works with a wide variety of technology clients, ranging from multinational Fortune 500 corporations to more entrepreneurial businesses, on myriad accounting, tax and other financial issues.

ABOUT BDO

BDO is the brand name for BDO USA, LLP, a U.S. professional services firm providing assurance, tax, and advisory services to a wide range of publicly traded and privately held companies. For more than 100 years, BDO has provided quality service through the active involvement of skilled and committed professionals. The firm serves clients through more than 65 offices and over 740 independent alliance firm locations nationwide. As an independent Member Firm of BDO International Limited, BDO serves multi-national clients through a global network of more than 91,000 people working out of over 1,600 offices across 167 countries.

BDO USA, LLP, a Delaware limited liability partnership, is the U.S. member of BDO International Limited, a UK company limited by guarantee, and forms part of the international BDO network of independent member firms. BDO is the brand name for the BDO network and for each of the BDO Member Firms. For more information please visit: www.bdo.com.

People who know Technology, know BDO.

www.bdo.com/technology