THE SOFTWARE SECTOR HANDBOOK

Trends & valuations in the **software** market

How to **increase** the **value** & **saleability** of your software business

The multiple has a big impact on the value of your business. What number to apply in a valuation is based on a variety of factors. Ultimately, it boils down to the transferability, sustainability and scalability of your business.

THE SOFTWARE SECTOR HANDBOOK

Mixed reports of extremely high revenue multiples for 'unicorn' software businesses and more modest earnings multiples for other software opportunities can be confusing.

Discover which is right and, most importantly, which applies to your business.

Software is an exciting sector where the rewards for innovation, creativity and hard work can be spectacular.

However, the market can punish mistakes and I’ve seen some exceptional ideas never gain the traction they deserve.

With more than 20 years’ M&A experience, and over 350 successful transactions, we understand the software market. We know what makes a software company successful and enhances its value. There are common traits that improve the saleability and value of a software company.

The Software Handbook is designed to give you an informative market update. It condenses our knowledge of the software sector to deliver invaluable insight and tangible advice that helps you create a truly valuable software business.

I wish you every success for the future.

Rob Goddard
CEO & Founder
EvolutionCBS

HOW TO VALUE A SOFTWARE BUSINESS

The software sector can see some of the highest valuation multiples in M&A. Some software companies achieve a valuation based on a multiple of revenue, whilst others are valued on a multiple of earnings.

So which one is right and what applies to your business?

How to value a software business is a fierce debate among business owners, acquirers and advisors.

Valuing a software business ultimately distils down to two key elements:

1. Whether a multiple of revenue or earnings should be applied to the business
2. What the multiple number should be

The multiple number and whether this is applied to revenue or earnings can make a significant impact on the valuation of your business.

The size of the multiplier number essentially comes down to buyer confidence. The more confident the acquirer feels in making a return on their investment, the higher the multiple number will be.

	Revenue £m	EBITDA £m	Revenue Valuation £m	Earnings Valuation £m
Company A	2.00	0.25	8.00	2.25
Company B	5.00	1.00	30.00	14.00

Company A: 4x Revenue multiple and 9x EBITDA Earnings multiple applied
Company B: 6x Revenue multiple and 14x EBITDA Earnings multiple applied

“Looking at how a company generates cash is, usually, a great metric for measuring the value of a business. In software deals, however, current EBITDA may not be indicative of the potential growth of the company, making revenue multiples more suitable for fast-growing software businesses”

Kay Binns
Research Director
EvolutionCBS

“Buyers are willing to pay more for companies with established recurring revenue streams”

Steve Barry
Senior Client Director,
EvolutionCBS

REVENUE OR EARNINGS?

The M&A valuation benchmark of earnings before interest, tax, depreciation and amortisation (EBITDA) is almost exclusively used throughout the M&A industry.

However, EBITDA multiples aren't always the best value measure for software companies.

QUICK TEST
EBITDA or REVENUE MULTIPLE?

- The business isn't reliant upon the owner
- YoY revenue growth is more than 50%
- Recurring revenue exceeds 60% of sales
- Annual revenue exceeds £1m

If **every** statement above applies to your software business, then a revenue multiple may be more applicable to you.

The use of a revenue or EBITDA multiple will have a significant impact on the value of your business and both are commonly used in software transactions. So which one is right and what applies to your business?

Both are correct, but they are entirely different investment propositions. Which applies comes down to the **size and growth** of the acquisition opportunity.

Software companies make significant investments in growth which affect current EBITDA generation. Therefore, EBITDA is often not indicative of the future earnings potential of a software business.

Revenue multiples can make sense for growing software valuations. With a recurring revenue model and low churn rates, the future profits can expand significantly as the business matures.

IMPORTANT: The revenue valuation philosophy is entirely based on GROWTH.

Ultimately, all valuations boil down to profit. If a software business isn't growing significantly, then the revenue won't support the future forecasted profit, making a revenue multiple less applicable.

< Use the quick test tool to see if a revenue multiple is right for your business.

“We see common attributes that enhance value in successful software companies. Using this knowledge we help maximise the value of our client’s business”

Rob Goddard
CEO, EvolutionCBS

ENHANCING THE VALUE OF YOUR SOFTWARE COMPANY

The multiple has a big impact on the value of your business. The number applied in a valuation is based on a variety of factors and an acquirer's confidence in the transferability, sustainability and scalability of your business.

Which attributes drive the multiple higher in software businesses?

SECURE YOUR IP

Protected intellectual property (IP) is attractive to an acquirer and it's a standard due diligence request. If your IP allows you to do something no one else can, this will enhance value. IP should be protected in the early stages of your business' development. If not, retroactively secure IP ahead of a sale.

Any individual or third-party company involved in writing code or development should sign an IP assignment for their output. This is increasingly relevant as contractors are hired from freelancer marketplaces.

IMPLEMENT STRONG MANAGEMENT

Establish and prove you have a dedicated, strong management team in place that run the business day-to-day. Staff and infrastructure are key in a transaction, and demonstrating the business isn't reliant upon you will reduce the perception of risk to an acquirer and ultimately allow you to exit sooner.

KNOW YOUR CUSTOMERS

A stable, contracted client base is vital to enhancing value. Strategic buyers often seek cross and up-selling opportunities and access to predictable income (perhaps in new territories) that provide a platform for growth.

When it comes to software, metrics are vital in convincing buyers of a company's strength. Seasoned acquirers will closely inspect your monthly recurring revenue, churn rates, Customer Acquisition Cost (CAC) and Customer Lifetime Value (LTV), retention and your cash burn rate.

INTEGRATE

Where possible, ensure your products easily integrate with other third-party plugins. Interoperability increases the lifecycle and value of a product, introduces other sources of revenue, resale opportunities and partner deals – all enhancing value to an acquirer.

MAXIMISE CONTRACTED REVENUE

Software companies that can demonstrate a high proportion of recurring revenue are, on average, twice as valuable as companies that sell perpetual licences. Aim to have a higher proportion of monthly recurring revenue than annually recurring revenue as buyers are more confident in validating MRR forecasts.

Retaining customers also drives value. Aim for a gross monthly churn rate under 1% (without accounting for up-sells) and a net monthly churn rate that is negative (up-sells greater than gross churn).

GROWTH IS KEY

Growth is vital to software companies and has a significant impact on valuation. The average SaaS company, with revenue growth at c.25% year-on-year, is valued at around three to four times recurring revenue. However, a company with similar revenues growing at c.50% year-on- year would be valued at around double that.

Value is enhanced when you have a defensible position, international appeal and a business that is forecasting strong growth. Your business will be most valuable when operating in an expanding market (buoyed by regulation, legislation, supply and demand etc.) and you're outperforming the competition.

DIVERSIFY YOUR CHANNELS

Acquire customers from multiple channels (organic search, affiliate, paid etc.) Having diversified channels reduces the dependency on one channel and demonstrates your products' ability to be monetised in multiple ways. Software businesses that have successful paid and organic channels demand a premium from acquirers.

OUTSOURCE

Effectively and reliably outsourcing development and customer support can add an increase to your multiple of 0.5x – 0.75x. Outsourcing reduces the buyer's assumed owner replacement cost and lifts the business' earnings for multiplication – driving valuation higher.

"Few acquirers want an SaaS business that is in decline and few owners want to sell a rapidly growing company. The ideal is to sell with consistent results and a modestly upward trend. The faster the business is growing, the more this pushes the multiple towards the premium end"

Steve Barry

Senior Client Director, EvolutionCBS

EXIT PLANNING

Carefully planning your exit timing is key to extracting a premium multiple.

When is the best time to sell your software business?

AGE OF BUSINESS

An older software business demonstrates sustainability and it's easier to substantiate future growth on the back of past performances and data.

In general, software businesses start to command premium multiples from 3 years plus. Younger businesses are saleable, but this may affect the multiple/deal structure and will require acquirers more tolerant of risk.

PRODUCT LIFECYCLE

All software needs investment and development to keep up with market requirements. Every SaaS business is unique in its development requirements and the development roadmap can be dictated by customers, competition or owner ambition.

To secure a premium multiple, it's usually best to market your business with the product at a high point of its development lifecycle. This gives the new owner confidence in mid-term trading ahead of any major developments.

RECURRING REVENUE

The full impact of recurring revenue varies by industry and business model, but software companies that can demonstrate recurring revenue attract a premium price.

Recurring revenue can double the value of software companies.

The full impact of recurring revenue varies by industry and business model, but we've seen software companies that can demonstrate recurring revenue attract an average revenue valuation multiple of 5x Last Twelve Months (LTM) recurringrevenue.

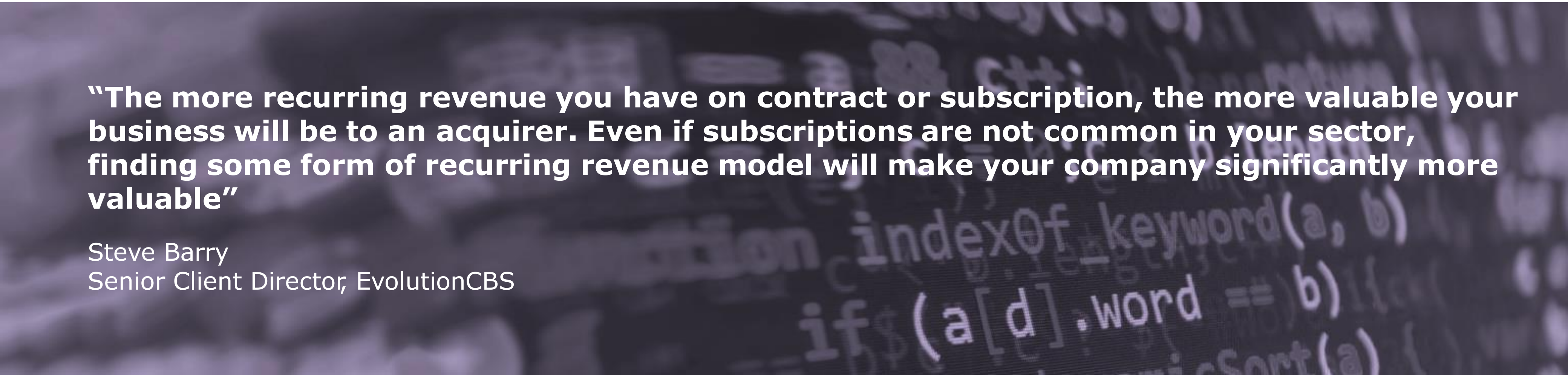
This compares to a 3x LTM revenue multiple for software companies with a perpetual license model.

Recurring revenue enhances confidence:

Reduced Risk & Enhanced Growth Potential: Recurring revenue serves as a buffer for income fluctuations. These businesses are perceived to be less risky and present more opportunities for growth.

Revenue & Cash Flow Confidence: Acquirers can be confident in recurring revenue from day one. It gives a buyer security that they can repay loans and meet financial obligations.

Stable & Predictable: Businesses with recurring revenue are more predictable. Owners forecast revenue months in advance and create budgets with increased certainty.



"The more recurring revenue you have on contract or subscription, the more valuable your business will be to an acquirer. Even if subscriptions are not common in your sector, finding some form of recurring revenue model will make your company significantly more valuable"

Steve Barry
Senior Client Director, EvolutionCBS

> **“Lifetime plans and perpetual licenses erode value in a software business”**
>
> Kay Binns
> Research Director
> EvolutionCBS

Monthly Recurring Revenue (MRR) vs Annual Recurring Revenue (ARR)

With software businesses, there is always the temptation to sell reduced annual plans to increase top-line revenue, improve cash flow and generate income to reinvest for growth.

There can be a business need to do this (especially in smaller SaaS companies), but in terms of valuation it may limit the business.

Focusing on selling monthly plans may reduce growth, but it is key to achieving the highest valuations. Monthly recurring revenue is often valued two times higher than equivalent revenue from lifetime plans – which outweighs the short-term cash flow boost.

> “The average SaaS business we sell has a 3:1 ratio of MRR to ARR – this is an ideal mix to maximise valuation as they often have years of churn data.
>
> SaaS products with a higher ratio of annual plans would see a lower valuation as the revenues are generally less predictable.”
>
> Mike Whittle
> Managing Director
> EvolutionCBS

Churn: What’s an acceptable rate?

Customer metrics are of vital importance for software business owners. They also enable acquirers to appraise the customer base and quality of a target’s revenue.

Discover the ideal rate of churn for your software business

Low churn allows recurring revenues to grow. This improves the growth rate and reduces the risk over the long term.

A high churn rate indicates to acquirers that the offering does not meet customer need and that there is limited/diminishing demand and stronger competitor offerings.

WHAT’S AN ACCEPTABLE CHURN RATE?

Finding a universally accepted rate of revenue churn is difficult. Generally, Private Equity acquirers find companies with an annual churn rate between 5 – 7% (0.42 – 0.58% monthly) most attractive.

When looking at large SaaS companies for a guide, c.70% have an annual churn of less than 10%; with c.75% of these having an annual churn of 5% or under.

In practice churn rates vary depending on the customers you serve.

Software companies serving small businesses will often operate with higher annual churn; around 30 – 60% (2.5 - 5% monthly churn rate). This is due to the volatility of a smaller customer base and less sticky customer acquisition channels.

A mid-tier customer base would see an annual churn rate between 12 and 24% (1 and 2% per month); whilst SaaS companies servicing the Enterprise sector will often have less than 10% annual churn.

CUSTOMER ACQUISITION COST (CAC) AND CUSTOMER LIFETIME VALUE (CLTV)

CLTV is the average amount of revenue you earn from a customer throughout the time they are paying for your service.

The higher your CLTV is, the more valuable each new customer is to your business.

A CLTV/CAC ratio of 3 is ideal for most SaaS businesses. This ensures the company will still generate healthy profits in the event of a dip in CLTV or spike in CAC.

"Software companies serving smaller customers will typically see a higher rate of churn. As spend per customer grows, SaaS companies can afford to invest more in retaining their customers - which improves the rate of churn"

Kay Binns

Research Director, EvolutionCBS

VALUATION CHECKLIST

We've developed a Valuation Checklist to help you keep track of your software business. It enables you to understand your company's current strengths and identify areas that will enhance its value.

Where can you enhance value in your software business?

OPERATIONS

- Our business is more than 3 years old
- All our IP is properly protected
- There is a proven, strong management team in place
- We are free from any high-tech requirements of the Owner
- Running our business does not require any technical knowledge
- We offer unique advantages
- Our product is in a high point of its development life-cycle
- Our product integrates with third party plugins
- We successfully outsource development and/or customer service

FINANCIAL

- Our Gross and net income has grown YoY for the past 3 years
- A new owner can replicate our cost structure (or make savings)
- Our business is free of any financial anomalies
- All revenue streams can be transferred to a new Owner
- The earnings potential of our business is independent of the current owner (i.e. no significant owner-specific relationships)
- There is a significant proportion of contracted recurring revenue (in excess of 60% of sales)

Tick all those which apply

CUSTOMER BASE

- We attract customers from diverse acquisition Channels
- We know why customers leave us
- We know our MRR, Churn Rate, CAC, CLTV & Burn Rates
- Our CLTV/CAC ratio 3 or higher
- Our annual churn rate is less than 10%

MARKET & NICHE

- There is low competition in our niche
- There are high barriers to market entry
- Our niche is growing
- There are expansion opportunities in our market

Tick all those which apply

The Results

<5 ✓

The valuation and saleability of your software company is likely to be significantly improved with some business enhancements and growth

5 – 10 ✓

Your software business is saleable and will attract a good multiple. With guidance to implement small changes and growth, the multiple and value of your business could be enhanced.

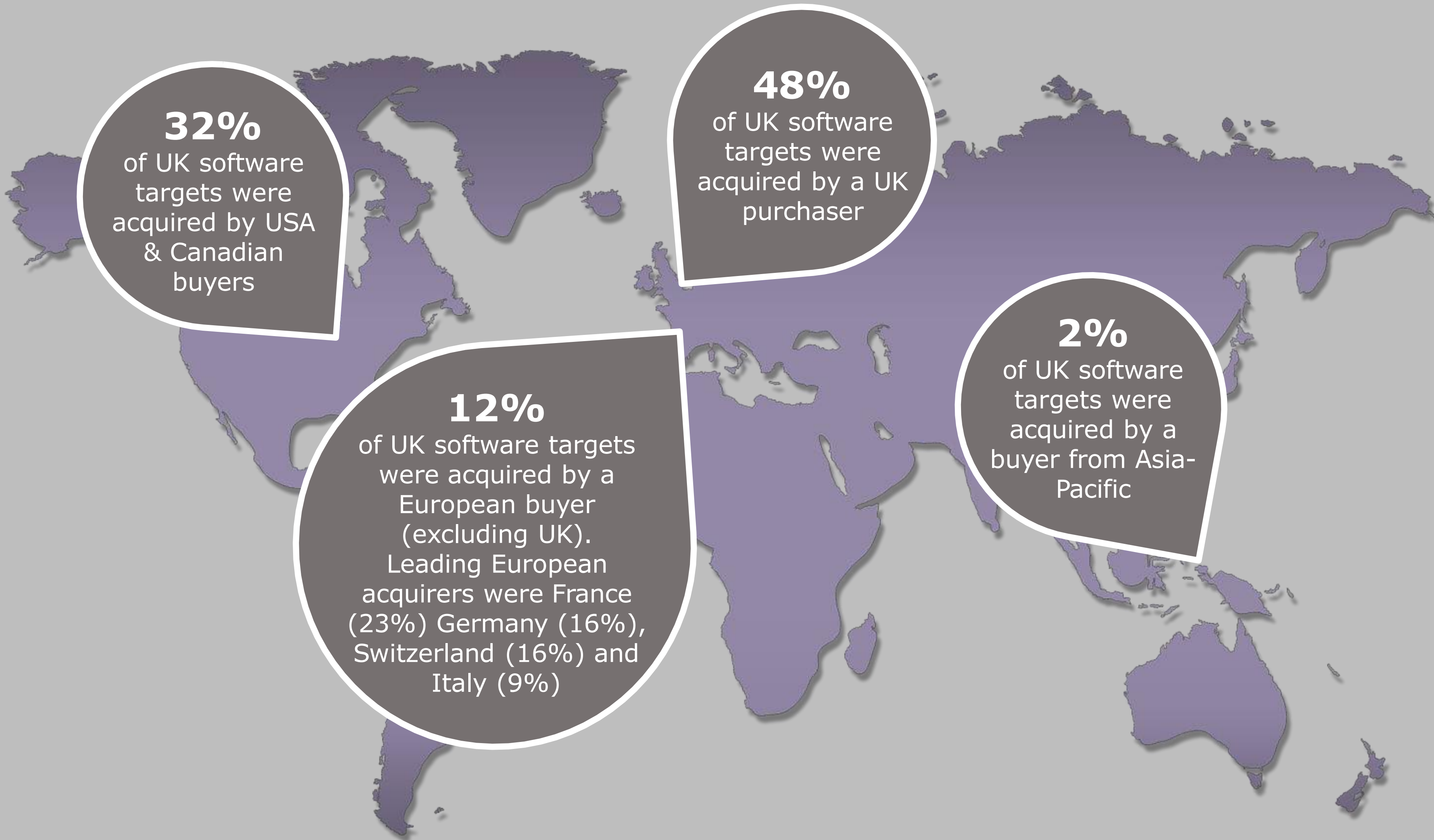
11 -20 ✓

You have a very saleable software company that is likely to command a strong multiple of revenues or earnings.

>20 ✓

You have a highly attractive and saleable software company that is likely to command a market-leading multiple of revenues or earnings.

THE SOFTWARE M&A LANDSCAPE



Source: S&P Capital IQ

Category Valuations
eCommerce software, Enterprise Resource Planning (ERP), and Business Intelligence software continue to lead the way in average EV/Revenue multiples over the last three years.

Category Volumes
Over the past 36 months, CRM and Marketing software represents the highest deal count of all the software product categories. Historically this segment has accounted for more transactions than the next two largest categories combined (Analytics & Business Intelligence (BI) and Communication & Collaboration).

Communication & Collaboration software transactions peaked in the 2017 and whilst we have not seen these levels since we consider the increase in flexible working environments is likely to see this category grow in the coming years.

Software M&A Acquirer Type Breakdown

TRADE vs FINANCIAL ACQUIRERS

The software market has consistently attracted investment from financial acquirers. Financial investors buying directly into the sector has hovered around 10% of total transaction volume for the past three years.

This demonstrates the sector's attractiveness, confidence in future growth and the presence of innovative acquisition opportunities that attract financial investors.

The nature of the software market with its large enterprises seeking significant growth (usually via blockbuster acquisition), and the constant stream of smaller, innovative companies emerging, ensures the sector is ripe for PE consolidation.

Over the past 36 months, **Private Equity (PE) backed strategic acquirers have been the most active segment of the software buyer landscape**.

PE-backed strategic acquirers make up 38% of total transaction-volume – outperforming private and public strategic acquirers.

Source S&P Capital IQ

EVOLUTIONCBS: SOFTWARE CASE STUDY

Rimilia is a leading SaaS intelligent automation company serving finance functions of global enterprises. Its award-winning solutions are at the cognitive end of the Robotic Process Automation (RPA) spectrum; highly intuitive and self-learning.

Rimilia acquired by Kennet Partners & Eight Roads Ventures.

COMPANY	Rimilia
REVENUE	£3.29m
EBITDA	£0.88m
DEAL DATE	July 2017
WHY SELL?	Facilitate Global Growth
DEAL VALUE	**£19.03m**
RESULTS	**7.78x** LTM Revenue **21.52x** LTM Adjusted EBITDA **252%** value increase above accountancy valuation
KEY STATS	**88** Acquirers Identified **32** IMs Requested **13** Meetings **03** Offers

Rimilia Intelligent finance solutions Acquired by Kennet 8° EIGHT ROADS

"Evolution's integrity, knowledge and experience was impressive and the team's dedication throughout was nothing short of outstanding.

Thanks for all of your collective efforts in getting us over the line.

Your tenacity and the personal input kept focus on completing the deal and ensuring it stayed right for us"

Chris McGibbon
Rimilia

OUR SOFTWARE SUCCESS IN NUMBERS

9
Average number of acquirer **meetings** per software client

16.3x
Average LTM EBITDA multiple in our software deals

119
Average number of **buyers** identified per software client

4
Average number of **offers** per software client

5.8x
Average LTM Revenue multiple in our software deals

133%
Average increase in software client value vs accountant valuation

£9.44m
Average software deal value

EVOLUTION CBS

SOFTWARE EXPERTISE

Rob Goddard
CEO & Founder

Since 2002, Rob has been responsible for the sale of 350 privately-owned UK businesses equating to more than £2 billion in transaction value.

Steve Barry
Senior Client Director

30 years' proven success in the Fintech, Software and Banking sectors. Steve has extensive M&A, growth & post-acquisition integration experience & delivered more than £50m of software transactions in the past 36 months

Kay Binns
Research Director

30 years' experience in the technology sector and 10 years' M&A experience Kay has been involved with transactions totalling over £100 million. She delivers industry analysis, acquisitions and business exits in the software sector.

Tailored to you…

EvolutionCBS Limited provides industry-leading corporate finance advice to private business owners.

If you would like to meet the team to understand more about how to **enhance the value** of your software business, its saleability or how to grow your business, please contact Claire Fortmuller, Head of Operations, +44 (0) 118 334 7783, cfortmuller@evolutioncbs.co.uk to arrange a complimentary, confidential consultation tailored to your business.

EvolutionCBS is a low volume, high service M&A boutique providing unparalleled, tailored M&A advisory solutions to emerging and mature software companies.

Proven success in software transactions.

EVOLUTIONCBS LIMITED
Merlin House
The Asmec Centre
Brunel Road
Theale
Berkshire
RG7 4AB

T: +44 (0)118 959 8224
E: info@evolutioncbs.co.uk
W: evolutioncbs.co.uk

SERVICES

GROW
Prepare for exit in the medium term, whilst delivering significant business growth. Grow your company’s value and saleability through a structured Growth2Exit mentoring programme.

ACQUIRE
Deliver your growth objectives, maximise returns and enhance value in your corporate growth strategy through our tailored acquisition service.

EXIT
Achieve a premium exit price with a competitive sale environment generated through our comprehensive, bespoke business sale solution.

EVOLUTION CBS

GROW | ACQUIRE | EXIT