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WHITE PAPER

Key Value Drivers of Future of Work SaaS Businesses



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After the Dotcom bubble burst in 2000, many people criticised some investors' willingness to pay for growth at any cost as it was difficult for them to understand how high revenue growth, coupled with a lack of profits, could translate into extremely high valuations. People viewed this as a broken system, but the SaaS model did not exist back then.

When the post-global financial crisis bull market started in 2009, two-thirds of the c.950 SaaS companies recently surveyed by SaaS Capital were yet to be founded, and many of those that were around could well not have been pure SaaS solutions at the time – the SaaS business model is not very old. According to SaaS Capital's research, *"the businesses that failed in the last tech bubble were valued on metrics that were both poor indicators of business health ("eyeballs", anyone?) and were nowhere to be found in generally accepted accounting principles (GAAP). In contrast, SaaS companies can be properly valued based on metrics that are both good indicators of financial health and that can be tied directly to the company's GAAP filings".*

SaaS companies are well known to be almost entirely powered by data, and success is predicated on how management track and improve key KPIs that have a direct impact on value. We cover some of the key value drivers of SaaS businesses below.

Key Value Drivers

Growth in Annual Recurring Revenue
Recurring revenue streams are key to generating predictability around growth of a SaaS business and, as a result, buyers and investors inspect and monitor it very diligently. Annual Recurring Revenue (ARR) is the blood of a SaaS business and is typically calculated as follows:

ARR = MRR * 12
Where
Monthly Recurring Revenue (MRR) = Annual Contract Value (ACV) / 12
Where
ACV = [Total Contract Value (TCV) – Non-Recurring Fees] / No. Contract Years

The calculation of ACV should subtract non-recurring charges in order to capture only the recurring revenue component of the contract. Such charges include:

- trials which do not guarantee bookings
- one-time fees such as implementation, setup and upgrade fees
- other fees charged on a time and materials basis

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MRR is of similar importance to the ARR metric, but it is typically tracked and used by SaaS businesses that sell monthly or short-term contracts (typically B2C contracts).

Buyers and investors use ARR as a tool to estimate the business' growth potential because it is a solid metric that incorporates a high degree of predictability. Therefore, as mentioned earlier, ARR growth is considered by many as being the single most important value driver of a SaaS business. Quantitative research conducted over the years by various sources also indicates that higher ARR growth generally correlates with higher revenue multiples for valuation purposes.

Revenue Retention

Revenue retention (also referred to as dollar retention) is viewed by many as the most important measure in SaaS and translates directly to value. There are two ways to measure it:

- Gross Revenue Retention (GRR)

  It measures how much of the customer base has been kept year-on-year without considering the positive effect of expansion. It is calculated as follows:

  GRR = (Opening ARR – Downselling – Churn) / Opening ARR
  Or
  GRR = (Opening ARR – Contraction) / Opening ARR

  A healthy SaaS business has GRR of at least 90%, and very close to 100%.

- Net Revenue Retention (NRR)

  It is similar to GRR but considers the benefits of expansion. It is calculated as follows:

  NRR = (Opening ARR + New ARR + Upselling – Downselling – Churn) / Opening ARR
  Or
  NRR = (Opening ARR + Expansion – Contraction) / Opening ARR

  A healthy SaaS business has NRR of over 100% because the benefits of new sales and upselling to its customer base outweigh the negative effects of downselling and churn. Strong SaaS businesses have NRR in excess of 120%.

A business' ability to retain its customer base and grow revenue from it over time is the foundation for growth in a subscription-based model, and SaaS businesses that excel at this typically command higher valuation multiples.

Deferred Revenue

Deferred Revenue (also coined deferred income or unearned revenue) is another very important indicator of future growth of a SaaS business and the way it is treated in deal negotiations can add or subtract tremendous value to shareholders.

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Because of the specific nature of the SaaS business model, GAAP accounting rules dictate that companies must recognise revenue as the service is delivered, or over the full length of the contract, even if they make a huge up-front sale. These sales or “Bookings” are accounted for by creating a liability in the company’s balance sheet – a Deferred Revenue Liability – and a balancing asset that can be Cash if the customer pre-paid for the service or Accounts Receivable if the company expects to bill for and receive it in the future.

Then, as the company delivers the service to its customers, it recognises the corresponding proportion of revenue in its Income Statement and reduces its Deferred Revenue Liability by the same amount. As an example, for a 12-month contract, the company’s revenue in its Income Statement increases by 1/12th every month whilst deferred revenue decreases by the same 1/12th every month.

Because of this accounting treatment, revenue is a lagging indicator of the health and growth potential of a SaaS business, not a leading indicator. In a growing SaaS business, Deferred Revenue is a much better forward-looking indicator of its growth performance than revenue.

Customer Acquisition Cost

The Customer Acquisition Cost (CAC) indicates the expense incurred in the process of convincing a customer to purchase a product and is typically calculated as follows:

CAC = Total Sales & Marketing (S&M) Costs / No. of New Customers Added

S&M costs typically include total compensation of the sales team, digital marketing campaign costs and search engine marketing costs.

On its own, CAC does not add much information value because every SaaS business is different, but CAC becomes an invaluable source of information when compared to Customer Lifetime Value, as explained below. In general terms, the lower the CAC the better, provided that such lower levels are sustainable and in line with the long-term customer acquisition strategy of the business and its market/sector specificities.

Customer Lifetime Value

The Customer Lifetime Value (CLTV or simply LTV) refers to the profit brought in by a customer over the full length of the contract and is typically calculated as follows:

LTV = (ARPA * Gross Margin) / Churn

Where

Average Revenue Per Account (ARPA) = ARR / No. of Customers

Efficient businesses focus relentlessly on maximising LTV by increasing ARPA and/or margins and by minimising churn. Being able to upsell to customers and/or adopt a land-and-expand model where customer retention is at the epicentre of the business strategy helps maximise value.

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Churn
In simple terms, low churn means the business is doing a good job at keeping its customers happy, whereas high churn means the exact opposite. Churn is typically measured in two different ways:

- Logo Churn (or Customer Churn), which indicates the proportion of customers that churned in a given period (i.e. a year):

  Logo Churn = No. of Churned Customers / Opening No. of Customers

- Revenue Churn, which indicates the proportion of revenue lost due to churned customers as a proportion of total recurring revenue:

  Revenue Churn = % of ARR Lost / Opening ARR

Both metrics are important and should be considered separately, but it is generally accepted that a SaaS business with annual revenue churn:

- Below 3-5% is considered a strong performer
- Between 3-5% and 8-10% is considered an average performer
- Above 10% is considered a poor performer

However, B2B businesses tend to experience lower levels of churn when compared to B2C ones, particularly businesses that sell to large and enterprise customers as these tend to be stickier due to lengthier contracts and their unwillingness to incur substantial costs in switching software providers.

Furthermore, it is common practice for specialist investors to compare the revenue churn rate to the rate of new customer additions to determine whether the business is expanding or contracting on a net basis.

All in all, churn is arguably the main reason why SaaS businesses fail, so it is crucial to identify issues causing churn and resolve them as soon as possible. Even low levels of churn can be extremely damaging to a company's hopes for delivering growth, so buyers and investors are laser focused on it in the context of a transaction.

LTV-to-CAC Ratio
This important ratio combines the metrics covered above and measures the relationship between the lifetime value of a customer and the cost incurred to acquire that customer, which is effectively the Return on Investment (ROI). The ratio is calculated as follows:

LTV-to-CAC Ratio = LTV / CAC

Generally speaking, the LTV / CAC ratio of healthy SaaS businesses should be higher than 3.0x but the ratio tends to be (much) higher for B2B businesses than for B2C ones because the Average Contract Value (ACV) for large companies and enterprises tends to be much higher than for consumers and the incremental cost of acquiring those large customers does not increase proportionally. LTV-to-CAC ratios of enterprise-focused B2B businesses can be as high as 15.0x or above.

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Successful SaaS businesses track this key ratio very closely and understand that, generally, a ratio:

- Above 3.0x means that for every £1 spend in acquiring a customer, the customer is generating more than £3 in return which represents a ROI of >3.0x over the term of the contract. Businesses with high LTV/CAC ratios tend to command higher valuation multiples, provided that the high ratios do not mean the company has unsustainably decreased its CAC ahead of a transaction

- Below 3.0x means that the company is facing some difficulty monetising its newly acquired customers, the wrong acquisition strategies may be being used, the customer base may be too difficult to penetrate (i.e. low purchasing power), or a combination of these factors

- Below 1.0x means that the business spends more acquiring the customer than it is able to extract revenue from it during the term of the contract, which is unsustainable

Burn Rate

The Burn Rate measures the rate at which an early-stage SaaS business spends the cash it raised from equity and/or debt investors. The burn rate can be measured in two different ways:

- Gross Burn, which simply refers to the operational cash outflows over a certain time period (i.e. a year):

  Gross Burn = Total Cash Outflows

- Net Burn, which factors in the cash inflows generated from sales activity:

  Net Burn = Total Cash Inflows – Total Cash Outflows

A high burn rate does not correlate perfectly with poor performance as the business might be operating in a very competitive sector and investors may consider continuing to fund it if the product and the market opportunity look attractive from a strategic perspective – a sustainable high-growth scenario. However, as explained in our separate white paper *"SaaS vs Non-SaaS Future of Work Valuations"*, during challenging economic times investors become reluctant to invest in businesses that have high burn rates and are unable to show a clear path to profitability in the short-term.

Investors also tend to look at the Implied Runway of the business to understand how long the company will be able to run without requiring additional capital injections:

Implied Runway = Cash Balance / Burn Rate

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Burn Multiple
The Burn Multiple measures the amount an early-stage business is spending to generate incremental ARR and simply represents the burn rate as a multiple of its revenue growth:

Burn Multiple = Net Burn / Net New ARR
Where
Net New ARR = New ARR + Upselling – Downselling – Churn

This is an important metric for high-growth, early-stage businesses because it adds context by indicating the cost at which growth is being generated. Generally, investors rank businesses as follows in terms of their burn multiples:

- Less than 1.0x – Excellent performance
- Between 1.0x and 2.0x – Good performance
- Between 2.0x and 3.0x – Below average performance
- Above 3.0x – Bad performance

Investors prefer businesses that have lower burn multiples because those are able to generate incremental ARR more efficiently, which becomes a vital point in deteriorating market conditions.

Other key company-specific factors to consider for maximising value ahead of a transaction

Company Size
Businesses delivering less than £1m of ARR at the time of a transaction are typically seen by potential buyers as being too small and are considered to be more suitable for VC or growth capital investors, provided the business is experiencing good growth. Also, businesses delivering ARR in excess of £5m or experiencing hyper-growth typically attract a wider pool of investors, including private equity and larger strategic buyers

Revenue Concentration
Businesses that generate ARR from a wider range of high-quality customers are less risky for buyers and investors, but if they are able to demonstrate the ability to upsell to their customers over time (i.e. land and expand model), they are deemed to be less risky and therefore more valuable.

Owner Involvement
Businesses that are able to generate recurring revenue without relying heavily on its owners (i.e. strong technical second-tier management; strong team; outsourcing model) are typically deemed to be less risky by investors.

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Lead Conversion
Benchmark lead conversion rates for SaaS businesses depend on a variety of factors including the sales model being used and the market segment, but it is important to ensure that the conversion rates of the business are in line with industry benchmarks ahead of a transaction.

Quality of the Product
It goes without saying that buyers and investors are ultimately valuing the quality and scalability potential of the company's product, so it is good practice to launch any product updates some time ahead of a transaction and demonstrate traction. It is also important to have a detailed product roadmap and clearly articulate the next phases of product development required for maximum scalability.

Quality of the Source Code
A poorly documented and tested source code can be a deal-killer, so it is important to package it properly ahead of a transaction.

Other key market-specific factors to consider for maximising value ahead of a transaction

Competition
Investors tend to value businesses more highly if they are (or are expected to become) winners in a specific niche or vertical, so positioning the business against its direct competitors is very important. However, investors also invest in high-quality horizontal software businesses where growth at scale is achievable.

Market Size & Growth
The size of the market will ultimately determine the growth potential of the business so understanding the Total Addressable Market (TAM), Serviceable Addressable Market (SAM) and Serviceable Obtainable Market (SOM) is important. Being able to grow market share within a smaller but high-growth market is also very attractive to buyers and investors.

Industry Trends
Understanding and being able to embrace major shifts within an industry or sector typically distinguishes the winners from the losers in the medium to long term, so it is important to position the business correctly ahead of a transaction.

Economic Cycle
Over time, businesses experience expansion and contraction in economic cycles, so being able to adapt quickly to an often rapidly changing environment is key. A strategic and agile management team can add tremendous value in challenging markets and the converse is also true if management is slow to react or adapt.

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Inflation
Persistently high inflation typically results in central banks shifting from an expansionary monetary policy to a contractionary one to fight it. This has a major impact on many factors. It typically leads to a higher cost of debt via an increase in interest rates and an overall higher cost of capital, which negatively impacts company valuations. Profitability also tends to decline due to increased costs that are not entirely offset by higher sales prices. It is important for businesses to be able to make the necessary adjustments (i.e. avoiding long-term contracts on a discount; indexing contract value to a price index such as CPI; etc) ahead of a transaction in order to avoid a discount in valuation.

Conclusion

SaaS companies are almost entirely powered by data, and success is predicated on how management track and improve key KPIs that have a direct impact on value.

Of the various important KPIs available to SaaS businesses, we would highlight the following as being of particular relevance in the context of a transaction:

- **ARR Growth**
  ARR growth is considered to be the single most important value driver of a SaaS business and quantitative research conducted over the years by various sources indicates that higher ARR growth generally correlates with higher revenue multiples
- **Churn**
  Churn is arguably the main reason why SaaS businesses fail and even low levels of churn can be extremely damaging to a company's hopes for delivering growth
- **LTV-to-CAC Ratio**
  This important ratio measures the relationship between the lifetime value of a customer and the cost incurred to acquire that customer, which is effectively the Return on Investment (ROI)

There are also other company-specific and market-specific factors that businesses should consider ahead of a transaction in order to maximise shareholder value and these include:

- Having a healthy client spread
- Minimising owners' involvement if they desire to exit the business
- Getting ahead of competition
- Being agile and quickly adapt to the phase of the economic cycle

At Optima, we help Future of Work businesses position themselves optimally for a transaction and Future of Work investors invest in the most sought-after businesses in the UK and Europe.

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Related Article

Discover why Future of Work SaaS businesses tend to command higher valuations than non-SaaS ones in our article ***'SaaS vs Non-SaaS Future of Work Valuations'***.

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Optima is a London-based investment banking boutique specialising in M&A advisory services for human capital technology and services businesses. For over 25 years, our clients have trusted us to think strategically, execute precisely and deliver premium results on sales, acquisitions, recapitalisations and fundraisings.

We advise leaders throughout their entire corporate lifecycle from founder-led and investor-backed businesses to public companies. We combine deep sector expertise, unparalleled industry relationships and transaction execution excellence to consistently deliver exceptional outcomes.

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