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WHITE PAPER

SaaS vs Non-SaaS Future of Work Valuations



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Why do SaaS Future of Work businesses tend to command higher valuations than non-SaaS ones?

It is widely recognised that every business model provides unique challenges when it comes to valuation and the Software-as-a-Service (“SaaS”) one is no exception to this rule.

The SaaS business model arrived in the early 2000’s but has been rapidly growing in popularity since the post-global financial crisis bull market that started in 2009. The rapid adoption of this relatively new business model, facilitated by major advancements in cloud computing, required financial professionals, investors and business owners to learn about SaaS and understand how it impacts the valuation of B2B and B2C start ups, SMEs and enterprises.

Generally, SaaS can be referred to as a delivery model in which a centrally hosted software is licensed to customers via a subscription plan. Any company that leases its software through a central, cloud-based system is typically said to be a SaaS company.

SaaS is a more robust business model

There are several reasons why SaaS companies typically enjoy higher valuations than non-SaaS ones, including:

- **Recurring Revenue** – the SaaS subscription model generates a highly predictable stream of revenues that are typically long-term in nature and which do not fluctuate during the term of the contract

- **High-growth/scalability** – SaaS businesses provide a turn-key solution to customers by maintaining responsibility for the software, servers and data that allow their product to be seamlessly accessed by customers around the world via the cloud. This avoids customers having to make huge investments in IT infrastructure and maintenance in-house, providing SaaS businesses with the competitive edge they need to roll out their product much faster than non-SaaS businesses

- **Larger market** – due to the benefits of the cloud, a SaaS solution can be sold anywhere in the world without requiring local physical presence and therefore slashes any costs associated with local offices and headcount. This means that a SaaS business can easily sell its product overseas without having to meaningfully increase its cost base, exponentially increasing the size of its market and revenue potential, provided that the product meets the requirements of local markets (i.e. language; regulations; etc)

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- **Attractiveness/Momentum** – the benefits associated with the SaaS business model have attracted strategic players who are looking to acquire SaaS companies to increase their levels of recurring revenue and serve customers who increasingly prefer to buy SaaS products, and financial investors who see an incredible opportunity to invest in high growth businesses that have the potential to deliver superior returns. High demand from strategic acquirers and investors creates strong momentum for SaaS, which puts upward pressure on valuations

Furthermore, SaaS tends to deliver better customer retention not only because it provides more frequent upgrades to their services to keep end-users happy and drive better customer lifetime value, but also because the same version of the software is being provided to customers around the world which enables a single, centrally located customer support team to provide a better service at a much a lower cost

The challenging trade-off between growth and profitability

SaaS is a "winner-takes-all" market and this dynamic means that valuations tend to be more volatile when compared to valuations of non-SaaS businesses. The winner-takes-all phenomenon tends to create a clear division between very successful businesses that are on the path to become market leaders or the "winners" and less-successful businesses that do not deliver eye-catching KPIs and are deemed to become the "losers". Businesses identified as winners tend to command a hefty valuation premium due to increased demand from both investors and strategic acquirers, whereas businesses identified as losers tend to suffer a severe valuation discount and even prove unattractive to investors in some cases. Not many businesses are left in the in-between zone, which is challenging from a valuation perspective.

The question therefore is how can one distinguish the winners from the losers? This is a challenging exercise with many factors that come into play and we cover this in more detail in our ***'Key Value Drivers of Future of Work SaaS Businesses white paper.'***

Rule of 40: Revenue Growth + EBITDA Margin ≥ 40%

The Rule of 40 is one simple concept that helps us understand a key trade-off: growth vs profitability. For most non-SaaS businesses, the valuation debate revolves around choosing the best proxy for the business's future cash flows, which is often a generally accepted measure of profitability such as EBITDA. For SaaS companies, however, the EBITDA being generated today is not a good proxy for potential future earnings because SaaS businesses make significant upfront investments in growth (i.e. R&D), which suppress EBITDA in the short term. The corresponding revenue will only come over the term of the client contracts, which creates a mismatch between the timing of revenue and costs.

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Because of the winner-takes-all dynamics of SaaS, the valuation debate does not revolve around profitability but rather around how much profitability a business should be willing to sacrifice in order to invest for growth, which is the single most important value driver of a SaaS business as we explain in our article ***'Key Value Drivers of Future of Work SaaS Businesses'*** white paper. In general terms, the Rule of 40 indicates that the revenue growth % plus the EBITDA margin % of a healthy SaaS business should be equal to or greater than 40%, therefore businesses will be deemed to be performing well either by focusing on accelerating growth or by focusing on increasing profitability. However, it is important to understand that this valuation philosophy is entirely based on growth in the sense that if the business does not grow, the revenue will not be there to support profits in the future, which is the underlying key to valuation.

It is also important to note that earlier stage and smaller SaaS businesses will want to sacrifice more profits than growth in the short to medium term to acquire market share faster than their competitors and benefit from economies of scale, in order to become the winners more quickly. Larger, more mature SaaS businesses that have managed to establish themselves as winners in their respective markets, may choose to focus more on improving profitability by investing more heavily in customer retention/churn reduction, which is another key valuation driver.

Maximising value in favourable market conditions

From our experience, under favourable market conditions, we tend to see SaaS businesses deliver better value by investing in growth whereas non-SaaS businesses benefit more from improving profitability, as indicated in the table below:

Delivery Model	Primary Focus	Secondary Focus
SaaS	Growth	Profitability
Non-SaaS	Profitability	Growth

This is the result of the market typically assigning more weight to revenue multiples for SaaS and EBITDA multiples for non-SaaS businesses. The ultimate strategic plan for maximising value lies in finding the optimal balance between the often-conflicting targets of growth and profitability.

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Maximising value in challenging market conditions

It should not come as a surprise that managing and maximising the value of a business in challenging market conditions is more difficult than managing and maximising the value of the same business in favourable market conditions.

The post-global financial crisis bull market that began officially in March 2009 was fuelled by expansionary monetary policies adopted by central banks worldwide, which translated into record-low levels of interest rates, and which made it extremely cheap for businesses to borrow money. However, since 2022, central banks have adopted a contractionary monetary policy to fight inflation which, among other things, has caused:

- the cost of capital to spike much faster than most experts would have anticipated
- many publicly listed software and other technology companies to rapidly lose market cap because of the market pricing in lower values for many stocks
- a significant shift in focus from buyers and investors who prefer to buy/invest in profitable companies or at least companies which can clearly demonstrate they are on the path to profitability in the short-term

In uncertain times, buyers and investors prefer to buy/invest in profitable businesses which can weather the storm better. During such times, the losers tend to go out of business because they require capital to stay afloat but investors are reluctant to pour money into businesses that cannot provide a compelling story on how they will be able to return the capital to their investors.

Research has shown that during severe economic downturns, SaaS businesses that temporarily shifted their focus from growth to profitability were not only able to weather the storm but were also able to shift their focus back from profitability to growth much faster than businesses that took longer to prepare for the storm. Research conducted by SaaS Capital shows that, on average, revenue growth declined from 40% pre-recession to 10% immediately post-recession and businesses shifted from negative to positive EBITDA during the same period - a behaviour that is consistent with the Rule of 40 hypothesis. It is therefore important to understand that, during uncertain times, the focus of SaaS and non-SaaS businesses becomes the same - maximising profitability:

Delivery Model	Primary Focus	Secondary Focus
SaaS	Profitability	Growth
Non-SaaS	Profitability	Growth

The resilience of the SaaS business model to economic downturns further increases the value of SaaS businesses, as they do not suffer from major swings in revenue, earnings and cash flows like non-SaaS businesses do, making them better capital preservation investments.

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Country-specific differences

US-based SaaS businesses have outperformed European companies in terms of valuation multiples over the years. It is difficult to precisely explain the reason why this has happened, but a number of factors have contributed to this:

- A country with abundant capital such as the US can expand its capital-intensive sectors such as the technology sector at a faster pace than other countries. Consequently, the returns to capital rise more than in other countries, leading to a greater demand for investment, inducing higher capital inflows from abroad which further accelerates capital deployment. This becomes a virtuous circle;

- Due to better access to pools of capital, businesses in the US are able to focus more on growth (which tends to drive higher valuations) than on profitability. This is particularly important for earlier-stage businesses, where this can be a significant challenge;

- The ecosystem that is generated around larger pools of capital creates a powerful network effect and enables investors to become specialists in certain areas of technology, thereby adding value to companies and driving higher returns.

The combination of greater availability of capital, more developed private and public capital markets and a larger, more uniform (i.e. same language; cultural habits; etc) market, amongst other things, makes it easier for businesses in capital-intensive countries to be more competitive than their peers in locations with different economic drivers, therefore enabling them to take a bigger slice of the economic pie much faster.

However, differences in valuations between US and European companies tend to narrow considerably during economic downturns because of the shift in focus from growth to profitability. As European businesses tend to focus more on profitability than growth, they become relatively more attractive to investors.

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Conclusion

Future of Work SaaS businesses tend to be more valuable than non-SaaS ones because they:

- produce recurring revenue which is more valuable than non-recurring revenue because it translates into more predictable cash flows
- operate on a data-driven, high-margin, highly scalable business model that is designed to maximise customer retention and expansion
- attract a wider pool of buyers and investors that compete for rare assets, which in turn drives valuation multiples up

SaaS is a “winner-takes-all” market and this dynamic means that valuations tend to be more volatile when compared to valuations of non-SaaS businesses. The Rule of 40 helps articulate the challenging trade-off between growth and profitability that ultimately distinguishes the winners who benefit from premium valuations from the losers who face discounted valuations and sometimes bankruptcy.

Maximising the value of a SaaS business also involves:

- making difficult decisions on where to base its operations because businesses located in capital-intensive countries tend to have easier access to capital and benefit from powerful network externalities that enable them to focus more on growth, which typically drives higher valuations
- being agile in order be able to quickly adapt to a rapidly changing economic environment as well as to new industry trends

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 ***'Key Value Drivers of Future of Work SaaS Businesses'***.

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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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