Understanding Your Quality of Revenue

Daniel Bernstein
Senior Vice President
Yasmin Khodamoradi
Director of Valuation Services

CORUM

Corum Group Ltd.
19805 North Creek Parkway, Suite 300
Bothell, WA 98011
Tel. +1 425-455-8281
Fax: +1 425-451-8951

www.CorumGroup.com

Introduction

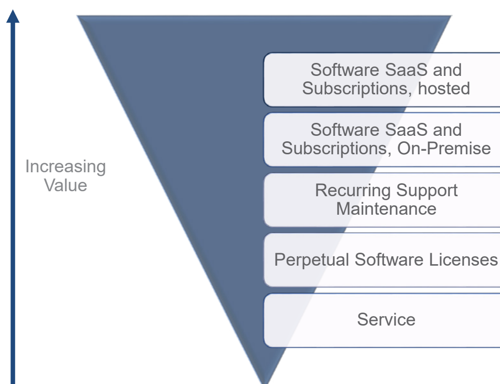
Sellers of software and related technology companies frequently assume that potential acquirers will focus entirely on a combination of top-line revenue, EBITDA and growth curve when valuing a company. That is just the beginning of the deeper revenue analyses performed by increasingly sophisticated buyers. While those metrics are important, a company's **quality of revenue** has a critical impact on how buyers will view and value that company. Both strategic and financial buyers will look at specific metrics relating to how revenue is generated.

These baseline metrics need to meet a certain level for many buyers to pursue a transaction. These same metrics will define how they value a business. A better understanding of quality of revenue can help CEOs make strategic decisions that will improve how buyers will value their company in the future. What follows is an abbreviated list of some of the critical financial metrics that buyers look for, particularly in B2B software companies. While these metrics mostly apply to companies with substantial sales and profits, small and pre-revenue companies can certainly be acquired for tremendous value based on non-financial strengths such as intellectual property, customers or an opportunity to enter new markets.

The Quality of Revenue Value Pyramid

Pure, recurring Software as a Service (SaaS) revenue has the highest value in a quality of revenue analysis. On-premise, recurring software (or maintenance) revenue is the next highest, while one-time software license revenue is not valued highly. One-time and non-recurring service revenue is valued the least of all the revenue types.

Figure A:The Quality of Revenue Value Pyramid

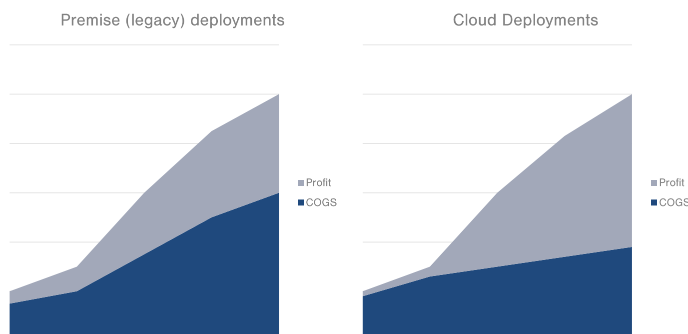


The valuation multiples assigned to each revenue type can vary from industry to industry. Disruptive technologies such as those described in Corum's Top 10 Disruptive Technology Trends tend to see higher multiples due to the strategic value they represent.

Cloud Deployment is the Future

Cloud-based companies are more valuable than companies that deploy on-premise, even if their present sales and earnings numbers look identical, and even if the initial costs of the cloud start out higher. Cloud deployments are more profitable at scale. Because buyers are buying the future, it is this future potential that makes revenue derived from cloud-based solutions more valuable than revenue derived from on-premise solutions. In this way, cloud deployments have the same valuation advantages over traditional software that software has traditionally had over other types of business.

Figure B: Premise vs. Cloud



There are costs associated with the deployment of software to individual customers. Whether it's assisting with server updates or flying across the globe to help them deploy on-site, the service burden increases along with the revenue. The more on-premise customers there are, the higher the costs incurred by engineers, customer support and travel.

To put it another way, in on-premise deployments, the cost of goods sold goes up with an increase in customers. On-premise deployments have a diminished capability to capitalize on economies of scale compared to cloud-based deployments. If you deploy your customers in the cloud, you can support them remotely and update them automatically. Everyone is on the same baseline hardware platform, and everyone has the same software version.

When transitioning to a cloud-based platform, there is an intermediate step: private clouds. A private cloud is an option to deploy to customers in their own sequestered hosting environment. This option still gives the support team the capability to update and service clients remotely which greatly reduces the cost of goods sold compared to traditional on-premise installation.

Software as a Service (SaaS)

SaaS, when paired with cloud-based deployment, remains the crown jewel of value creation. Buyers value SaaS companies highly because they deliver contracted revenue over a much longer period of time than traditional perpetual license models. A recurring subscription with a customer creates an annuity stream that will benefit the acquirer. They will pay handsomely for that revenue.

Small, cash-strapped companies often have difficulty moving to this model, particularly if they rely on large deals for injections of cash to fund their operation. One-time, multi-million-dollar deals – while attractive tactically – present little future value to an acquiring company. The revenue from a one-time perpetual license deal is in the rearview mirror. The buyer cannot capitalize on that license to generate more cash. Acquirers prefer deals spread over 12-, 24- or even 36-month contracts with renewals.

Recurring Revenue Misconceptions

There is a common misconception that follow-on revenue is the same as recurring revenue. If a customer is not contracted to purchase any products or recurring maintenance after buying the software license, but purchases these on a one-off basis, that's **follow-on revenue**. While you may be able to count on customers to come back and ask for more products and services, they are not contracted to do so.

Your customer's license to your software is not predicated on them buying add-ons. At any point, they may decide that they no longer need a service or enhancement and can still remain licensors of the software. This follow-on revenue is uncertain and will be heavily discounted by the buyer. Follow-on revenue is considered one-time revenue, not recurring. This revenue can disappear for any reason and is not under the company's control – thus, it is not valued as highly by an acquirer.

Recurring revenue is defined by a contract, which ensures that your customer's license agreement is predicated on recurring payments. If they stop paying for any reason, they will lose their license. While recurring deals may look like they are harder to negotiate, the lowered upfront cost should incentivize potential customers.

Software vs. Service

What happens when your biggest customer asks you to customize your software and deploy it to them as a managed service for a giant sum of money? Or asks for extensive additional implementation services at a generous rate? These scenarios may sound attractive, especially if they provide an opportunity to grow the business significantly. From a valuation perspective, though, this kind of service revenue can be a poison pill.

The addition of a service-heavy business to your software company diminishes the value of the software that you are creating. The purity of your recurring software business is contaminated by a larger support burden. Tech acquirers tend to avoid or penalize companies that have high variable costs associated with support. If it is possible for support to be outsourced, that is an opportunity to create a higher margin and show the merits of your software business on its own, without the support and associated services weighing it down.

When selling software that requires servicing, it can be made available to customers through a recurring service maintenance contract. While that revenue stream is not valued as highly as pure SaaS, maintenance contracts are still valued highly if they are high margin.

Churn Analysis

All buyers will take a close look at the churn, or customer attrition, of a software company, particularly a SaaS company. High churn is typically a symptom of a larger problem. Buyers perform churn analysis after accounting for your customers' recurring revenue as a step in the process of determining the full lifetime value of a customer. A high churn can quickly wipe out the advantages of the SaaS model.

Figure C: Example Churn Template

Customer ID	2014	2015	Δ 2014-2015	2016	Δ 2015-2016	2017	Δ 2016-2017	Δ 2014-2017
ID8032	$1,300,000	$1,200,000	-$100,000	$1,400,000	$200,000	$2,100,000	$700,000	$800,000
ID9039	$800,000	$835,000	$35,000	$700,000	-$135,000	$735,000	$35,000	-$65,000
...	...	...	...	...	...	...	...	...
Total	$35,000,000	$37,000,000	$2,000,000	$41,000,000	$4,000,000	$44,000,000	$3,000,000	$9,000,000

Usually, churn is calculated as a change, or "delta," in the revenue received from a customer between similar time periods. Sometimes a customer may not churn out fully but decrease their revenue over time, perhaps by lowering their level of subscription or not buying up to a maintenance service contract.

Churn should not be calculated solely based on numbers of customers lost. Rather, compare revenue snapshots by customers in specific time periods. An even more granular look at churn will split up different recurring sources of revenue, with SaaS and recurring service maintenance contracts examined separately.

Analyzing churn allows you to determine not only the health of the company but the entire customer ecosystem. Even cutting-edge software companies can be penalized if they sell into a market with unusually high client turnover. Typically, a yearly churn rate (calculated by revenue) of over 10% is considered problematic for most buyers, regardless of the ultimate cause of that churn.

The Impact of Location

Geographic concentration in revenue sources is often considered in a buyer's analysis of the quality of revenue. A successful deployment into larger markets will provide the buyer comfort that the business will continue to grow and build value. Smaller markets can become saturated quickly, so geographic diversity in customer revenue is your best strategic weapon.

Further, currency fluctuations can wreak havoc on revenue analysis. Measuring items like churn in your business's home currency allows you to maintain a more objective view of your business performance.

Understanding your Business

When it comes to analyzing your company's financial position, it's important to recognize how your company interacts with customers in terms of how it bills for its software and services. When examining comparable transactions, you need to look for companies that deploy to customers in a similar way and have a similar mix of revenue sources.

For example, a SaaS-based, cloud-hosted business may be worth quite a lot more than a traditional on-premise, perpetual license business even though they may be identical to one another in every other way. Just because there is a precedent transaction in your space doesn't mean that it's entirely applicable to you. Look at the mix of software and services, the nature of the deployment and any additional information on their customer concentration or churn before you start comparing your company to theirs.

Lifetime Value

$$LTV = \frac{\text{Recurring Revenue}}{\text{Churn}}$$

The lifetime value of each customer is calculated as a function of recurring revenue and churn. This metric helps acquirers calculate how much cash they can expect to receive from each customer over the lifetime of that customer. Recurring revenue and low churn rate invariably yield a higher valuation. Considering the quality of your revenue is not just a technique to understand your value as a business, it's a guide for how to build long-term value in your company.

Conclusion

Understanding buyer perspectives on revenue quality is vital when embarking on an M&A process. More important, though, is a disciplined, global process that properly positions your company to the buyer as a key building block to their future, and a distinct threat in the hands of competitors. Even in an auction process, though, where strategic questions are paramount, a strong foundation of high-quality revenue will serve to strongly support an Optimal Outcome process.

Curious about the value of your company in today's tech M&A market?

Contact Corum Group today to schedule a confidential conversation with one of our deal professionals.

Daniel Bernstein

As Corum Group Senior Vice President, Dan's focus is on enabling software and related technology companies to achive an optimal outcome through a disciplined M&A process, and has led deals globally in a variety of technology sectors. Dan has worked in many roles over a twenty year career in high technology, and prior to Corum was the founder and CEO of Sandlot Games Corporation, a leading casual games publisher and developer, which he sold to Digital Chocolate in 2011.

Prior to Sandlot Games, Daniel Bernstein held director level positions in companies such as Wild Tangent and Monolith. Daniel holds a BS in Computer Science and an MA in Music Composition from the University of Virginia.

Yasmin Khodamoradi

Yasmin joined Corum Group in 2015, providing research on valuations and assisting with sell-side M&A transactions. As Director of Valuation Services, she has helped dozens of tech companies determine their value in the market, with a focus on enterprise software and SaaS, IT services, and vertical sector solutions. Previously, she worked for a fintech startup and a global angel investment firm. Yasmin graduated from the Foster School of Business at the University of Washington, specializing in Finance and International Business.

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