WHAT’S YOUR SAAS COMPANY WORTH?

This white paper is written for entrepreneurs, angel investors, and the management teams of SaaS businesses. The intent of the paper is to describe a valuation framework that stakeholders can use to more clearly articulate the value of their business as they negotiate with investors or buyers. We’ll also explore the role of strategic advisors – particularly investment bankers – in the valuation, money raising, or sale process.

THE STATE OF THE MARKET

Before we jump into outlining a valuation framework, let’s take a moment to assess the overall state of the market as it relates to SaaS companies. The good news is that public and private markets are now believers in the SaaS business model. Enterprise SaaS businesses are delivering tangible results for their customers. Therefore, they have outperformed the overall market as shown in the following chart which tracks the nine SaaS companies that have been public since 2007.

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When compared to other software segments, the SaaS “premium” is currently approaching 2x: with SaaS businesses trading at a median equity value to revenue multiple of 5.7 times revenue, vs. 3 times for non-SaaS software companies. The revenue
multiple for SaaS companies has been steady for the last 24 months at between 4.8 times and 5.7 times revenue and their recent run-up in valuation has been mostly driven by solid underlying financial performance.

M&A and IPO activity has also been active for public SaaS businesses. Four large publically traded SaaS companies have been acquired in the last 24 months, and there have been 14 IPO’s of SaaS companies in the same period.

In the private sector, M&A activity has remained robust, although valuation data is mixed. The 451 Group tracked almost 250 M&A events in 2011 (including other “cloud” companies - although predominately SaaS) and 2012 is on pace to exceed 2011, which will make four consecutive years of growth in both the number of events and total transaction value.

In terms of valuation multiples for private M&A events, the 451 Group has compiled the following data. Interestingly, as you will note, M&A values have tailed off in the last 18 months after a 150% increase from 2005 until 2010. It is probably too early to call this a definitive trend just yet as the private data has a timing lag, but it is something to watch closely when the final 2012 numbers come in.

While this macro level data about valuations is helpful to provide context and assess general market conditions, when it’s time to sell your SaaS business or seek outside investor capital, your ultimate valuation will be driven by a host of factors that are highly specific to your company and founders. To maximize value, individual company characteristics need to be carefully evaluated, isolated, and placed in the overall context of the broader market.
The partners at SaaS Capital and DH Capital have assisted in the sale or financing of literally hundreds of businesses over the years. Almost all these businesses were either SaaS companies or had a very similar recurring revenue business model. Drawing from these experiences, we have put together a list of value drivers every seller should pay attention to as they go about preparing for the sale of their company or their company’s stock (an equity raise).

Mix Equal Parts Passion and Math

Before we begin digging into the math, let’s first discuss tone. VC’s in particular – and sometimes corporate buyers – do appreciate entrepreneurial zeal. In many cases they would not invest/acquire without it. That said, when it comes to valuation, buyers must be able to rationalize a purchase price with numerical valuation metrics. The seller’s job is to get prospective buyers/investors excited about the business, and then provide them with the data and arguments to support the highest possible price. Passion attracts interest. Math sets the valuation.

Generally speaking, it’s a myth that investors and buyers are looking for unsophisticated sellers. For every unsophisticated seller that prices their business too low, there are a dozen more sellers with unrealistically high expectations. Sellers who have not educated themselves on valuation approaches can be predisposed to thinking they are being “taken advantage of” in negotiations. If that is the mindset of the seller going into a process, most negotiations stall and the buyers will move on to other opportunities. The best way to avoid this pitfall on both sides is to increase the knowledge base about how these transactions are typically priced and structured.

One Number Matters

Simply put, SaaS businesses are traded on a multiple of annualized recurring revenue (ARR). All the other drivers of valuation are tied back to this benchmark in order to support a higher or lower multiple. For an emerging SaaS company, annualized recurring revenue is the best shorthand number for benchmarking the real valuation driver of all businesses: the present value of its future cash flows. In short, today’s value is based on estimating how big the future profits of the company are likely to be, and what are the chances that they will actually materialize? For SaaS businesses, the best place to start that estimate is their current size (ARR), and adjust from there. All other valuation discussions such as growth rate, retention rate, market size, contribution margins, CAC ratios, etc. are adjustments to the multiple that is then applied to the ARR.

Why not use EBITDA to benchmark valuation as is done in most other industries?

For most businesses, a company’s current cash flow as measured by EBITDA (earnings before interest, depreciation, amortization, and taxes) is the best proxy for future cash flow and is therefore, the basis of its valuation. For SaaS companies, however, the EBITDA being generated today (possibly none) is not a good proxy for future potential earnings because growing SaaS businesses are making large, up-front, and completely discretionary investments in growth which are all expensed in current EBITDA.

Assuming similar gross margins and customer acquisition costs, larger SaaS businesses are able to generate larger profits and are therefore worth more regardless of their current EBITDA. The larger businesses simply have more scale and have the capacity to generate larger future profits as they enter a more mature phase of their lifecycle. For these reasons, current revenue is a better proxy for value than current EBITDA/profits.

Salesforce.com is the best example to demonstrate this point. They continue to invest heavily in growing the business to the point that their current profits are negative, yet their market cap is approximately $20 billion and their growth is 25% to 30% per annum.
VALUATION DRIVERS: WHAT DETERMINES YOUR REVENUE MULTIPLE?

Based on our research and experience in the field, the following items are the key valuation drivers for SaaS businesses. Other nuances of your business will undoubtedly impact valuation, but these are the broad-based value drivers.

Listed in order of importance, they are:

1. Growth
2. Addressable Market Size
3. Customer Retention
4. Gross Margins
5. Customer Acquisition Costs

Valuation Driver #1 – GROWTH

How long will it take to get big, and how likely is it to happen?

Historical growth rate is the single biggest driver of valuation. In fact, it dwarfs all other factors. The reason growth is so important is that it indicates both the timing and the likelihood of future profits. Faster growth means larger profits sooner, and because of the recurring revenue model, high historical growth rates are a good indication of future growth rates.

Using public market data, the relationship between growth and a higher revenue multiple is shown in the chart below. The correlation is not 100%, but it’s strong. The faster growing businesses are getting the higher multiples, while the slower growing businesses are getting lower multiples. The outliers on this chart can generally be explained by a large or small Addressable Market, which we will discuss later.

As the chart indicates, there are no public SaaS businesses with growth rates below 20% that have a revenue multiple above 3.5. A 25% level growth rate is a good, bottom of the range, target for emerging private SaaS businesses. Higher growth rates are expected in younger venture backed companies, and lower growth rates are acceptable in more established bootstrapped companies.

In the private capital market, the growth imperative accounts not only for differences in valuation, but also in the likelihood of success. Slow growth SaaS businesses are difficult to get funded at any price. These businesses and their existing investors and management must find a way to demonstrate some organic growth that can then be leveraged with additional capital. Only then will it be worthwhile to invest the time and energy in external fundraising. In a recent conversation with a leading SaaS VC firm they commented, “Show me anything that’s growing.”

On the M&A front, the growth imperative is almost as strong. There are exceptions when a corporate buyer is looking for a very specific need that can only be filled by a single company; however, buying criteria generally revolve around growth. “I can’t even take an acquisition opportunity to my CEO unless they are growing faster than we are,” said an SVP in a large SaaS business that is currently growing at 29%.

Sometimes debt financing is used to get a growth program launched in order to demonstrate growth in the business prior to a sale or equity round.
Valuation Driver #2 – MARKET SIZE
How big can your business be?

This is a key valuation battleground. Your team must be able to simply and credibly articulate that they will generate large profits in the future. Keeping in mind that small businesses in small markets do not generate large profits, it is the size of your addressable market that establishes the upper bounds of your future profits and therefore your valuation.

For this reason, VC’s and buyers dig deeply into the company’s market size. They want to understand your “total addressable market.” In other words, if you sold all your current products to all the potential buyers of those products, how big would your company be? Investors will not pay a $50 million valuation for a SaaS business in a $100 million market. The upside is too limited.

In our experience, managers and owners do not do a good job framing the market-sizing discussion. This is unfortunate because as operators you are in a much better position to build the case. With a little bit of research, the management team can put together a well-organized addressable market presentation that will generally be accepted by the investor.

Because market size has a big impact on valuation, you might want to consider launching into new markets, new geographies, or launching new products before a sale or investment round. Just a few paying customers in the new markets will allow your company to credibly “claim” the expanded market even though it’s not yet fully developed.

Driver #3 – CUSTOMER RETENTION
What is the risk the business might actually shrink and fail?

Customer retention is a significant driver of valuation because it touches upon all the key factors that impact the perceived future cash flows of a SaaS business. High retention increases the size of the business, improves the growth rate of the business, and very importantly, reduces the risk of loss.

Our prior analysis on this topic, No Churn: Keep Customers and Improve Your Valuation, has shown that the multi-factor impact of improved customer retention over time can double or triple the value of the company. Buyers and investors will pay extra for businesses they perceive as having little risk of losing customers.

Driver #4 – GROSS MARGIN
Given your revenue, how much money can you make?

While it’s true net income and EBITDA are not direct valuation drivers for growing SaaS businesses, gross margins are relevant. Gross margins strongly indicate the profitability of your business when it reaches a more mature phase. Gross margins also determine how much revenue your business can channel back into sales, marketing, and product development and therefore, how capital efficient the business will be. For these reasons, the less direct costs required to deliver your SaaS revenue, the more valuable that revenue is.

SaaS businesses must be able to clearly identify costs associated with professional services versus the costs associated with the product itself. Those two revenue streams are typically valued separately. It does not matter as much what margins you are earning on services; although losing money is always a drain on cash and not ideal. Buyers are more interested in the gross margin you are earning on the core product.

Of note here is the question of revenue mix between professional services and the SaaS product itself. While it is true that “given a specific level of revenue”, the less it is professional services revenue, the greater the valuation. In the real world, though, no one ever “gives” you a level of revenue. The bottom line is this; if you can make money on professional services and it helps solidify or grow your SaaS license revenue, more services revenue is a good thing and it does add incremental value.
Gross margins for SaaS businesses are measured many different ways. There are no standards. We recommend including all direct hosting and customer support costs in SaaS license COGS as the best “operational” number that provides the proper visibility into the business’ actual operating leverage. Including sales commissions and allocated overhead in COGS clouds the number, reduces its usefulness, and is an unnecessary negative in a valuation discussion.

For SaaS revenue streams, (excluding professional services), gross margins are typically 85% to 95% and a SaaS business can increase its valuation by intentionally focusing on improving its gross margin. For professional services, we now see the vast majority of SaaS businesses making some money on this activity and not providing it as a loss leader as they commonly did 5 years ago.

**Driver #5 – CUSTOMER ACQUISITION EFFICIENCY**

*How much money will it take to grow?*

Both investors and strategic buyers are typically looking to continue growing a SaaS business by deploying more capital in sales and marketing. How efficient the business is at converting that spending into new customers is highly relevant to both projected future cash flows at maturity, and also the amount of capital it will take to grow.

High customer acquisition cost (CAC) businesses require more capital to grow and, thereby, diminish overall returns whether the buyer is a VC or a corporation. Your “CAC Ratio” is also relevant to your ultimate valuation because it compares customer acquisition cost to the lifetime value of a customer. The better that ratio, the higher profitability will be over time.

A related metric to CAC is the “average length of sale”. Buyers and investors want to understand this metric because it can significantly impact the timing of future cash flows and quarterly earnings. The shorter the sales cycle the faster the payback. Short sales cycles also reduce risk because long sales cycle business can be off-track for several quarters or years before an issue becomes apparent.

**MAKING YOUR CASE FOR VALUATION**

1. **Frame the Argument**

First and foremost, you need to frame your current growth rate in the most positive light possible. If you are having a great bookings quarter, speak to your upcoming MRR growth that is already known in your forecast. Conversely, if your bookings are flat or down, then shift the valuation discussion to look instead at year-over-year growth or a longer historical revenue growth rate. If you have little growth, you will need to identify specific business trends that support an argument for future growth. Such trends might include a recently launched product, a specific web campaign, or a new channel partner. And as was mentioned earlier, if your business does not have significant growth above 15% or so, it simply might not be worth the time and effort to try and raise equity capital.

Carefully construct your P&L to highlight operating leverage. Consider what your incremental costs are to service new business and focus your COGS to include just those items. Also be conversant on how much EBITDA the business can generate if
it chose to slow down its growth investments in sales and marketing. That calculation is a credible floor for a valuation discussion and also highlights the fact you do not “have to” sell or raise money.

Next, build an accurate and credible “public comparable” argument based on your industry (Healthcare), or type of product (CRM), or growth rate (all companies greater than 27%). See which natural cohort of public SaaS companies gives you the highest multiple and then be ready to defend that decision.

Consider leveraging your churn data if it’s good. In the enterprise, low 90’s revenue retention is “pretty good” and above 95% would be something to brag about. Buyers/investors should absolutely pay-up for low-churn businesses for all the reasons articulated earlier.

Finally, know your addressable market well and be able to demonstrate your growth plans. Start with current products being sold in existing geographies and then expand outward to the most credible expansion story. That might be a new product to the same target customers, or simply expanding the geography to Europe, or Asia. Work to demonstrate that if your company is successful it will be BIG.

2. Dealing with Deferred Revenue

If, like many SaaS businesses, you are billing your customers in advance for your services, there will be deferred revenue on your balance sheet. Most buyers and VC’s will deduct deferred revenue from the price they are willing to pay for your company’s “equity value” because it is negative working capital and represents a claim on the future cash flows of the business. When they do this, they are treating deferred revenue like bank debt.

In reality, however, SaaS deferred revenue is not like other liabilities. SaaS companies reduce their deferred revenue liability by delivering services over time. Delivering SaaS services costs pennies on the dollar compared to the deferred revenue balance, so the future cash drain on the organization is actually much lower than the number on the balance sheet. Our suggested approach is to multiply the deferred balance by the cost of goods sold percentage and treat the remaining amount as the real liability. That is the true future cash cost of delivering the revenue.

Further, the bill in advance structure that created the deferred revenue liability will deliver significant cash-flow benefits to the buyers as they grow the business in the future. Rather than debating accounting practices, your argument should also incorporate the question, “Is our business really less valuable because we collect our cash up-front?”

3. Arguments vs. Outcomes

During a sale or investment process, it helps to remember that the VC’s and Corporate Development folks that you will encounter have probably made and debated many of the above points dozens of times. For the typical entrepreneur and CEO, however, buying or selling a business happens just a few times in a career. That being said, the techniques and arguments used during a typical deal are not all that complicated and knowing them in advance will help you to negotiate a higher value for your business.

Based on our experience, the arguments and techniques we have outlined above will lead to more productive and relevant discussions with investors or buyers. However, at the end of the day, the “market” sets the valuation and constructing the ideal marketplace for your business is an extremely important part of the process. Multiple simultaneous interested parties, or the perception of such, will help maximize the company’s value (even if you are a bad negotiator). Orchestrating such a process on your own or with the help of your board and lawyers can sometimes work, however, it’s a time consuming and time sensitive process and there are many situations where it makes sense to seek professional outside assistance.
GETTING “BUY” WITH A LITTLE HELP FROM YOUR FRIENDS

But let’s be realistic, as the CEO/Founder of your business you are probably thinking:

“Why should I hire some Hermes-tie-wearing investment banker, when I built this company from my garage and know it better than anyone? And let’s face it, I have a good idea of the best strategic buyers, the VC’s call me once a month, and I have a very successful angel investor on my board.”

This kind of thinking is not uncommon, and in some cases, not without merit. That said, are several important and well grounded reasons to consider hiring a professional advisor:

Reason #1: Full Time Help

It’s very logical to look to your board of directors and your current investors to form the foundation of your advisory team. You know the skills that these people can lend and you already have a rapport established. But your investors and the members of your Board are – at best – part-time participants in your business. They might be helpful to queue up a few conversations but they aren’t going to be available to be the “point person” throughout the entire process. A big part of the value-add of an outside advisor is their singular focus on driving a complex process forward. The CEO or Founder can still be very involved, but it will just be at crucial junctures in the process, not orchestrating all the details.

The one sure way to lower your company’s valuation during the investment process is to have a period of financial underperformance while dialogues are ongoing. If you are spending at least 50% of your time meeting with buyers, generating books, revising projections, negotiating deal points, meeting with your board, communicating with your investors, etc., and you are doing this over a 6 to 12 months timeline, how will your business perform? Some investors and buyers will intentionally slow down the process to see how your company performs during the time they are engaged with you. Small deviations from plan have large symbolic significance in this period and most companies will suffer if their senior team is highly distracted.

Reason #2: You don’t do this for a living

In any given transaction there are a myriad of deal points, structural nuances, tax strategies, indemnification provisions, escrow accounts, working capital adjustments, and other issues that arise that need to be quickly and professionally addressed. A good lawyer can resolve some of these issues but not all and, they typically lack “the forest from the trees” perspective. “Over-lawyered” deals grind to a halt and many times fail to close. Speed is an important component of closing a good deal, and an experienced advisor can quickly guide you through all the tactical deal points which are important, but numerous and complex.

Reason #3: Open Field Running

When starting down the path of considering your strategic options, it helps to remember that the key word is OPTIONS. The path you start on in a process might not be where you end up. An external advisor, familiar with a wide range of alternatives, can be invaluable for identifying the best initial strategy and navigating emergent opportunities. Any process you start can have several potential endings – a recapitalization, a classic operational pivot, a debt or equity raise, a merger, a sale, or a strategic partnership. A team that has experience with these different options can help you to identify when to possibly shift course and what direction to take.

Reason #4: You Need a Bad Cop

There is a significant chance that the day after closing you will be working with the team you have been negotiating with for the past month. Or, at your next board meeting, the
venture partner from the firm that invested in your company might be sitting next to you. Your investment banker’s job is to make sure that your relationships are not clouded by a last minute screaming match about the equity waterfall. Your banker is a buffer zone and the designated bad guy who can push harder than you can on deal points. An advisor can also more effectively negotiate the delicate deal points around compensation of the senior team members.

**Selecting an Investment Banker**

First and foremost, your advisor’s most important job will be to fully understand your company, operations, and management in an effort to help define an optimal “capital” strategy.

**Relevance counts** - Obviously, your choice of advisor can have a profound impact on your ultimate outcome. For this reason, you want to hire an investment banker with relevant experience in terms of deal size, industry expertise, business model experience, and they type of transaction. For SaaS, the business model and approach to value is not as closely tied to the traditional software model as people first suspected. As you are aware, SaaS businesses are not simply perpetual licensed software companies that chose to host and rent their product. The successful ones have a completely different approach to running the business and you want to make sure your advisor understands this nuance. Your advisor needs to assess the value of the strategic and intangible facets of your business and then bring that perspective to bear on any transaction.

**Flexibility is important** - How the transaction is negotiated can be critical and should be dictated by the specifics of your company. For example, it’s a myth that every transaction should go through a full-blown auction process in order to extract the best value. Larger businesses are usually sold to larger buyers with dedicated M&A staffs and therefore, they will benefit from a competitive auction process. Smaller deals may be best served by a patient negotiation with a targeted, logical buyer with the timing of the process dictated by the availability of the CEO. Your investment banker should have the depth of experience to determine the best strategy for your current situation.

**Commitment matters** - Make sure your advisor is committed to the transaction and the deal is of sufficient size that it

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✓ Most Likely  ❓ Questionable  ❌ Not Likely
is important to them. You don’t want your deal to be a training ground for a junior associate. Senior-level attention is something you should demand. It’s best to be clear up front about who will be working on your deal. Your deal will blow-up and reach a seemingly insurmountable impasse at some point. You need to feel comfortable that your investment banker will stay in the game and have the skills to help you manage any obstacles.

**A good relationship helps** – A company-based transaction may be one of the most important financial events in your life and will, most likely, take months to conclude. Make sure you trust, enjoy and respect your advisors. Your investment banker has to be comfortable communicating both good and bad news to you in an open and forthright manner.

### 3 BIGGEST MYTHS OF INVESTMENT BANKING

Are you ready to take the plunge and hire an investment banker? Then it might help to consider the following misconceptions and misunderstandings about investment banking.

**You have to hire a big bank**

1. **For simplicity sake, investment bankers are of two ilk – large “bulge bracket” brand names and boutique firms. Both types of investment banks have strengths and weaknesses. With larger banks you hire the panache of their brand and have access to more people and resources. But at the same time you face the danger of having your deal assigned to a junior staff person or losing the attention of your team to a bigger deal that comes along. Generally speaking, the larger banks are good for the larger deals ($500 million and above), deals that involve a large strategic buyer of your company, or for an IPO. Otherwise, you will typically see the senior banker only at their initial “pitch”, and then never again.

Conversely, at a boutique bank your deal is generally more important to the firm and generates greater attention and more personal service. Small banks are filled with senior folks who prefer to work with entrepreneurs and not sub-committees of the board of directors. With a boutique investment bank you are more likely to hire a person based on your relationship – not the firm.

2. **The Rolodex Myth**

   The Rolodex Myth is one of the two greatest lies (the second is discussed next) in investment banking. The Rolodex Myth revolves around the concept that access is magic. OK, this might be true for billion dollar deals in certain industries. In software and technology – SaaS specifically – access is not a problem. CEOs and decision makers are constantly on the lookout for new technology, brains, and bodies. In addition, the half-life of contacts at specific technology companies is relatively brief as people are highly mobile assets and always on the lookout for new challenges and opportunities.

3. **The Big Number Pitch**

   The Big Number Pitch is the second biggest lie of investment banking. Do not hire the banker who tells you the biggest number. It’s likely you already have pretty good idea of what the market value is for your company. Don’t fall for a big number; in fact, run away from a banker who tells you a multiple of your number to win the business. It’s not worth your time.
WORKING WITH YOUR ADVISOR

Once you select an investment banker they will initially be involved with company valuation activity. They can offer different perspectives and formulate alternative strategies for selling, fundraising or buying. They’ll put together the information that defines your company and quantifies the value to a complete outsider – a critical part of any process that is sometimes the hardest task for a CEO to do personally. Whether it’s for fundraising or a sale of the business, your banker will create an overview presentation and your “book”, run the process, deal with the various parties, build and enforce a timeline, present you with strategic alternatives, and assist with the myriad of other issues including tax strategies, assets versus stock sale, employment agreements and any other terms and conditions.

When putting together an advisor team for your process it’s important to create areas of responsibility and control. To use a sports team analogy, members of your management team are players and your investment banker plays the role of player/coach or “quarterback.” Various other advisors, including accountants and lawyers, play different offensive and defensive roles. The pre-game work the entire team does is vital, including the preparation of any material that will be part of the due diligence process. The lawyer is responsible for preparing the company to answer all questions regarding intellectual property and the legal ramifications of any capital structure issues. As with any game, practice and pre-game anticipation are vital components. During the process the team will have to work together to answer questions, provide documentation, and construct alternatives to surmount problems.

What is all this help going to cost me?
Investment bankers typically require a small retainer, reimbursement for direct expenses and a success fee. The success fee is usually a percent of the value of the transaction, which can be the amount of debt or equity raised or the value received in a sale transaction. The percentage of fee is determined by many factors including the size of the transaction, the agreed upon scope of the engagement, the time allocation and the size of the team that will be assigned to the deal. Since advisors have some minimum threshold under which an assignment is insufficiently remunerative, smaller deals ($5 million or less) are likely to have large percentage fees (5% or more), while very large deals ($500 million and more) often have fees of 1.0% or less.

Many bankers are also open to structures that have a lower fee in the event the company accepts a transaction that it views as mediocre and pay handsomely in the event of stellar results. Remember, this is a success fee. Ultimately, the company decides whether or not to complete a transaction and incur a fee.

Getting the most from your advisory relationships
When it comes to advisors, we suggest solidifying relationships with key internal and external folks early in the process. The more knowledge that you can share with your advisors, the better they will work with your business. Involving the right folks up-front and hiring the right investment banker will enhance any process and improve your outcomes when the future of your company is on the line.

CONCLUSIONS

Years of hard work and perseverance are required to build a successful business. Selling all or part of that business is an important undertaking with long-term implications and a large financial impact. Being informed and educated about the process and the techniques used to determine the business’ value are important first steps. Getting some professional help to guide you through the process can also help improve the outcome in many cases. We hope this whitepaper has provided some helpful information and contextual guidance to generate the best possible outcome.
ABOUT SAAS CAPITAL

Founded in 2006, SaaS Capital is the pioneer provider of debt-based growth capital for SaaS companies. By leveraging the predictable revenue streams of the SaaS business model, SaaS Capital’s debt facilities allow SaaS companies to accelerate future cash-flow streams to fund operations today. SaaS Capital’s products provide more availability than traditional bank financing, and are structured with flexible terms to meet the needs of growing SaaS businesses. Through its partnership with DH Capital, SaaS Capital can also assist with a variety of M&A and capital raising advisory services. To learn more about SaaS Capital, visit www.saas-capital.com.