

By David Joncas, Managing Director



SaaS...A Better Mousetrap?

Software as a Service (SaaS) is an application delivery model whereby vendors develop, host, and deliver software applications over the web. SaaS vendors believe they've built a better mousetrap, and we tend to agree. Although SaaS valuation multiples clearly reflect this bullish, broader market sentiment, some posit that SaaS valuations, which trade at approximately 4-8x LTM revenue, are excessive when compared to those of traditional perpetual license software companies, which trade at approximately 2-3x LTM revenue. Careful consideration of the SaaS industry, which analysts project will grow at a compound annual growth rate (CAGR) of 22.1% to \$11.5 billion by 2011¹, suggests SaaS valuation multiples may be justified.

But growth and market size don't tell the entire SaaS valuation story. In fact, a core driver of valuation multiples is deeply rooted in SaaS *revenue quality*. SaaS *revenue quality*, which Harris Williams & Co. defines in terms of contribution margin and revenue visibility (recurring revenue as a percent of total sales), is generally superior to that of traditional perpetual license software companies that generally grant customers the right to use applications in perpetuity in exchange for a one time license fee and a modest recurring annual software maintenance fee. SaaS *revenue quality* is "built in" and driven by the basic mechanics of the SaaS model, which sells and delivers software on a hosted basis, according to annual or multi-year subscription licenses. As a result, the annual *recurring* component of SaaS vendor revenue can easily account for approximately 80% to 90% of total annual projected sales, compared to approximately 40% to 50% for many perpetual license software companies.

Review of Harris Williams & Co.'s Software Revenue Quality Index ("Index") underscores the magnitude of the *revenue quality* disparity amongst SaaS and perpetual license software vendors. The Index, which analyzes revenue contribution margin and estimated revenue visibility, depicts a profound delineation among SaaS and perpetual license software companies as far as revenue visibility is concerned and underscores the higher "quality" nature of SaaS revenue. Superior *revenue quality*, in addition to attractive SaaS industry growth prospects, is fueling SaaS valuation premiums.

The SaaS delivery model also facilitates a number of compelling operating characteristics, including strong cash flow (subscriptions are often paid one year in advance), shorter sales cycles, scale economies and an efficient, cost effective mechanism for deploying SaaS applications to both enterprise and small medium business (SMB) customers. SaaS customers too, enjoy numerous benefits, including greater capital efficiency (lower upfront costs), rapid application deployment, lower professional services implementation and IT infrastructure costs, web-based access, and continuous application improvements, to name a few.

¹ Gartner, "SaaS Outpacing Enterprise Software Growth", August 3, 2007 (2006-2011 CAGR period).



While a quick Google search² suggests SaaS is not yet part of the Main St. vernacular, SaaS is clearly mainstream on Wall St. and within the broader enterprise software community. One need only consider the positive impact Salesforce.com has had on the software industry and the recent wave of SaaS M&A and IPOs, including Salary.com Inc., DemandTec, Inc., and NetSuite Inc., to see growing investor excitement and understand the threat to perpetual license software vendors is looming.

Harris Williams & Co. recently advised on the sale of Appriss, Inc. to Bain Capital Ventures and JMI Equity. Appriss, a SaaS industry veteran, is the leading provider of automated victim information and notification SaaS solutions to federal, state, and local criminal justice and law enforcement agencies nationwide. Appriss extols the classic virtues of a pure play SaaS company (e.g., high customer retention rates, strong cash flow and exceptional revenue visibility) and has deployed solutions to more than 1,800 counties in 41 states.

While early SaaS companies focused on delivering horizontal applications (e.g., Human Capital Management or “HCM”), serving vertical markets (e.g., Healthcare IT), or selling to small medium business (SMB) customers, we believe the SaaS delivery model will increasingly challenge software market incumbents as customers seek to acquire new software capabilities or upgrade existing platforms. The Harris Williams & Co. Tech Group has been very active in the SaaS sector and is seeing increased demand for both horizontal and vertically focused SaaS solutions. In addition, we are beginning to see SaaS vendors make promising inroads beyond the SMB market and growing receptivity within the Fortune 1000 customer ranks, a trend we expect will accelerate as SaaS moves solidly into the mainstream.

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David Joncas, a senior member of Harris Williams & Co.'s Technology Group, leads the firm's software and IT services sector initiatives. With 15 years of technology and services industry experience, Mr. Joncas has advised on more than 50 public and private sellside, buy-side, and cross-border M&A transactions spanning enterprise software, healthcare IT, financial technology, energy IT, IT services and digital media. Mr. Joncas has completed transactions with technology industry leaders including Agfa-Gevaert Group, Automatic Data Processing, Hewlett-Packard Company, IBM Corporation, McKesson, Inc., Red Hat Inc., SBC Communications, Inc., SS&C Technologies, Inc., and WebMD, Inc., among others.

² As of December 21st, 2007, a Google search for “SaaS” returned just 1.35 million references compared to 65.5 million for “ERP” (Enterprise Resource Planning) and 2.7 billion for “software”.