

How To Invest In Software As A Service (SaaS) Companies

Helped by the pandemic and global lockdowns, SaaS companies have started gaining significant traction in 2020. Investors have reported crazy returns of >200% in 2020 alone.



Comparison of growth in a year between Q4 2020 and Q4 2019

Zoom grew its revenue by 355% and trading at EV/ Revenue next 12 months of 38x	Shopify grew its revenue by 95% and trading at EV/ Revenue next 12 months of 33x	CrowdStrike grew its revenue by 84% and trading at EV/ Revenue next 12 months of 29x	Slack grew its revenue by 46% and trading at EV/ Revenue next 12 months of 14x
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What is SaaS (Software as Service)?

SaaS refers to **Software as a Service**. These companies provide a delivery model for a centrally located, (usually) **cloud-based software that is licensed** to their customers.

SaaS companies **host the software for their clients and charge them a subscription fee on an ongoing basis**. Traditionally, software companies offer self-hosted solutions for a one-time licence fee.

Key Differences

Traditional Software

Software was usually bought and physically distributed on CD-ROM

Software is installed in the computer

Users pay a one time fee to have access

Updates are done manually to have the latest version

No security or maintenance

SaaS (Software as a Service)

Most software is now located on the cloud, and you can simply connect to it via the internet

No need to install and run software application on your computer. Hosted on a remote server by a third-party provider. Everything is available over the internet

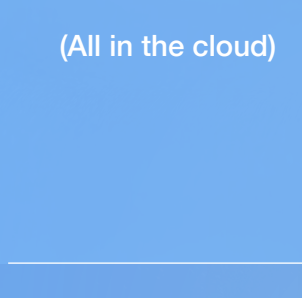
Users pay an ongoing subscription fee to have access

The latest version of software is automatically provided or updated to the users

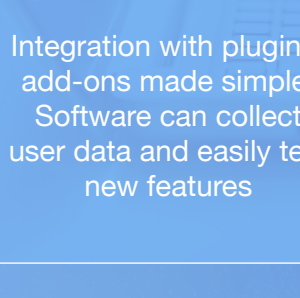
Inclusive, offering security, compliance, and maintenance as part of the cost

Key Game Changing Traits And Benefits Of SaaS Model

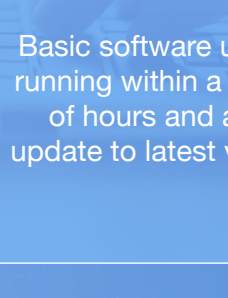
Efficiency & Peace Of Mind



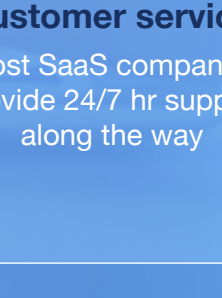
Easy Access
(All in the cloud)



Easy Integration
Integration with plugins/add-ons made simple. Software can collect user data and easily test new features

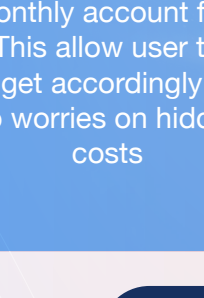


Boost Productivity
Basic software up and running within a matter of hours and auto update to latest version



Access to customer service
Most SaaS companies provide 24/7 hr support along the way

Licensing & Payment Structure



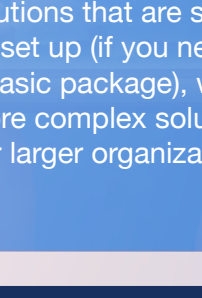
Flexible and clear licensing model

Subscription model with a fixed, inclusive monthly account fee. This allows user to budget accordingly with no worries on hidden costs



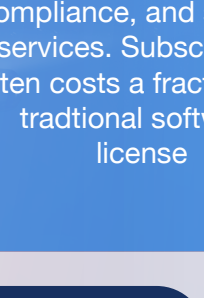
Customised Solution

Personalized logins, customized to each person's access level



Scalability And Integration.

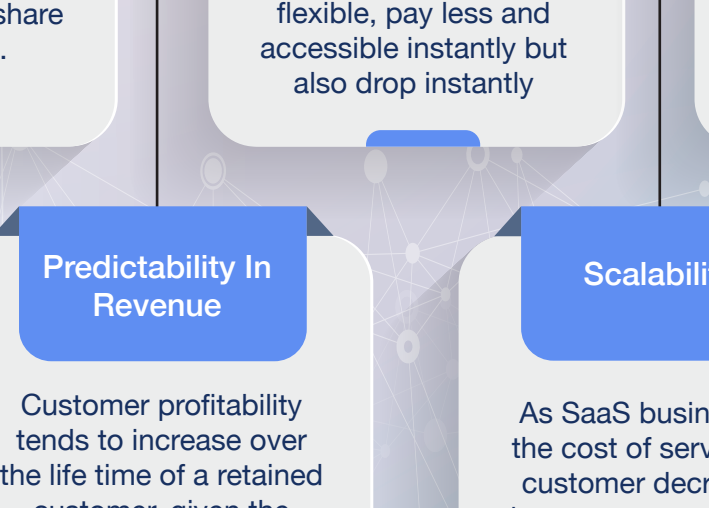
SaaS providers also offer out-of-the-box solutions that are simple to set up (if you need a basic package), with more complex solutions for larger organizations



Lower Costs

Most subscriptions include maintenance, compliance, and security services. Subscription often costs a fraction of a traditional software license

Why Investors Love SaaS?



High Growth Rate And Average Valuation Is High

SaaS are disrupting the legacy industries and are capturing market share at a rapid rate.

A Proven Model

SaaS is an embodiment of everything the modern world encompasses; people want things to be flexible, pay less and accessible instantly but also drop instantly

Typical Exit Revenue Multiples Are High

This makes injecting money into a SaaS business potentially very lucrative for investors

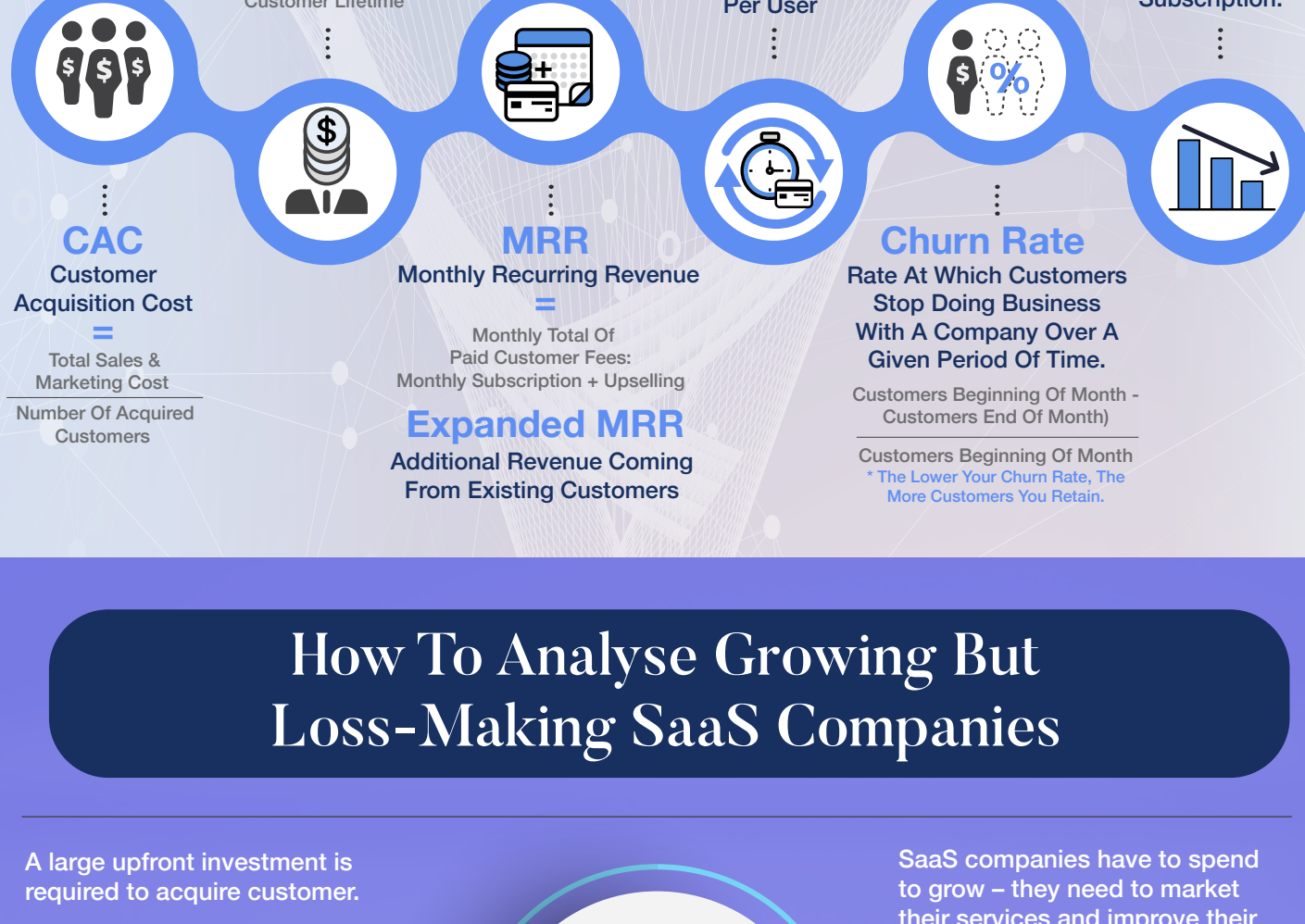
Predictability In Revenue

Customer profitability tends to increase over the life time of a retained customer, given the SaaS subscription based model of recurring revenue

Scalability

As SaaS business scale, the cost of servicing each customer decreases. As long as company controls its churn, the business becomes a cash flow machine

Fundamental SaaS Metrics To Understand



How To Analyse Growing But Loss-Making SaaS Companies

A large upfront investment is required to acquire customer.

Profits from that investment can only be recovered over a long period of time as each customer is billed a subscription fee each month that is significantly smaller than the cost to acquire them.

Many of them are reporting losses, even as their customer base grows. This is inevitable because these SaaS stocks are currently in a race to outspend their competitors, in order to gain market share.

A good SaaS company is one which can immediately report profits if they decide to stop spending on acquisition.

Customer retention is important to any growing company because it measures not only how successful they are at acquiring new customers, but how successful they are at satisfying existing customers.

Monetization has the largest impact on the bottom line. It gives the necessary leverage to scale growth without exhausting all of the resources.

Improving retention and monetization has 4x the impact of focusing on acquisition.

Acquiring Customers



SaaS companies have to spend to grow – they need to market their services and improve their infrastructure to accommodate more customers. However, a better SaaS company is capable of acquiring a customer at a lower cost. This also translates to a shorter window to profitability per customer.

As the market matures, a good SaaS company is also able to reduce its cost per acquisition.

Retaining Customers



Good SaaS companies keep their users satisfied and paying over a longer period. This translates to increase in recurring revenue over time and lower expenses on customer acquisition.

How many customers from the previous *cohort are still around?
*Cohort refers to a group of customers or contracts that begin in the same period (monthly/ quarter of a year)

Monetizing customers



What is the strategy to grow customer value (increase Average Revenue Per User)?

On top of keeping their customers happy, good SaaS companies are also capable of getting their existing customers to spend more.

This could be done through higher priced plans, cross selling of complementary products, add-on and more.

What Makes A Good SaaS Business?

Key SaaS Business Metrics

LTV > 3 X CAC

The company is on a healthy growth if the Lifetime Value of a customer is at least 3 times the cost of acquiring the customer

MONTHS TO RECOVER CAC < 12 MONTHS

This is a good predictor of how well a SaaS business will perform. *The profitability tends to be anemic if the time to recover CAC extends beyond 12 months. *Refer to Chart A

NET NEW MRR + EXPANDED MRR > CHURN

The revenue is growing if the total of Net New Monthly Recurring Revenue and Additional Monthly recurring revenue from existing customers is more than Churn

MRR to ARR = 5:1

Even if it slows growth, focusing on selling monthly plans is key to achieving higher valuations.

SaaS products with a higher ratio of annual plans would see a lower valuation as the revenues are less predictable.

Impact of Months to Recover CAC on Cash Flow



Low Churn

Low churn will allow recurring revenues to grow, improving the growth rate and reducing the risk of value loss over the long term. (This is provided that there is consistent flow of new customers at an acceptable cost of acquisition rate.)

Key SaaS Investing Metrics

Price to Sale Ratio =

$$\frac{\text{Market capitalisation}}{\text{Company's sales in previous 12 months}}$$

This tells you how overpriced the stock is in the markets.

A P/S of 1 means you are paying \$1 for every \$1 sales that the company brings in.

Compound Annual Growth Rate (CAGR)

This gives you an idea of the company's growth rate.

$$\text{CAGR} = \left(\frac{\text{EV}}{\text{BV}} \right)^{\frac{1}{n}} - 1$$

where:
EV=Ending value
BV=Beginning value
n=Number of years

Higher the CAGR, the better.

Other Factors To Consider

Customer Acquisition Channel

A premium SaaS business will tend to acquire customers from a multitude of channels, be it organic search, affiliate, paid or otherwise. Having a diversity of channels not only reduces the dependency on one channel but also proves its monetization in multiple ways.

Many small- and mid-market SaaS businesses build their customer acquisition from content marketing before exploring paid and affiliate channels. It can be a worthwhile experiment to trial 3-6 months ahead of an exit to see whether they yield positive ROI. Not only will this improve the value of the business' earnings (and thus the SDE for valuation) but it will demonstrate to investors that the business can be monetized in multiple channels.

Channel Competition

A business is considered to have a strong platform for organic customer acquisition if it has a strong backlink profile and ranks well for a number of relevant keywords

Small- and mid-market SaaS business who engage in price wars in paid search with competitors to outbid in a particular niche will suffer a short-lived PPC lifecycle.

Conversion

The appraisal of customer acquisition channels are the associated conversion and cost attached to each. Pay attention to the conversion-to-trial ratio and conversion-to-paid ratio, together with the associated cost of acquisition.

Competition

There is generally high development costs associated with the business model. This makes it challenging for small and mid market SaaS business to compete in a highly competitive niche as it tends to find itself under-funded and unable to compete with the development efforts and features of better-funded, VC-backed SaaS companies.