

DECODING B2B SOFTWARE INVESTMENTS



Transcript

Welcome to A&M Conversation With, a show where Alvarez and Marsal leaders discuss the trends impacting business today.

[00:00:15] Sue: Thank you for joining 'A&M Conversation with' a podcast series featuring Alvarez and Marsal's leaders discussing the trends impacting businesses today. In this edition, Dan and Simon will sit down to discuss investments in B2B enterprise software. So maybe we can kick off the session with some brief introductions. Dan, do you want to go ahead?

[00:00:37] Dan: Sure. Thanks, Sue. So, my name is Dan Angelucci. I'm a managing director based here in Singapore. I lead the digital technology services group for Southeast Asia and Australia. I've spent my career really looking. At software assets from various different angles, both from buying them, from selling them, and also from helping to advise them in the last few years in terms of my consulting career.

So I've got a very unique perspective, I think, on what makes these assets interesting and successful. And I think we've been able to take that into the market in terms of our discussions around particularly the private equity groups and where it is that we can find value in the assets that they are looking at.

So, I think we are relatively new into the region in Southeast Asia, Australia. But we've really accelerated our value in terms of being able to provide advisory services, not just around software, but around the larger private equity ecosystem and really be able to identify what makes assets interesting and why it is that PE companies should be interested in them.

So, I'm excited about having the discussion about enterprise software. So, Simon, why don't you introduce yourself?

[00:01:36] Simon: Thanks, Daniel. My name is Simon Ludwigs and I'm a director at our private equity and performance improvements practice here in Singapore. Actually, Dan played a key role in bringing me over from Germany. Before this, I was with A&M office in London. I'm a learned software engineer and IT program manager and after nearly a decade in the industry, I pivoted to private equity consulting. And since then I've been involved in dozens of pre deal activities, both on the buy side and sale side. I've also done quite a bit of post-merger integration work and stepped in as interim CTO. For my side, I believe this mix of hand on tech experience and business mind gives us a unique lens to view and handle these kinds of deals. So I'm really appreciate the chance to discuss our work and insights today.

[00:02:18] Sue: Thanks, Dan and thanks, Simon. So since this is a session about enterprise software, let's start off with an overview question. Why is enterprise software currently relevant and what do you see in the market that makes it so critical for businesses today?

[00:02:32] Dan: Sure. So I think the simple answer is that enterprise software is the engine that drives digital transformation.

So digital transformation in a lot of ways is about achieving how it is achieving scale and achieving economies of scale across your capabilities as an organization. So enterprise software is enabling that. For organizations, no matter what industry that they sit in, it doesn't matter if you're a machine tools player or if you're an auto manufacturer or if you're producing, widgets of any kind, digital has become an enabler in order to make you more productive, more effective and reach your customers in a better way.

So the result is that enterprise software is really driving value within these organizations and that makes it critical to make the right decisions around enterprise software and it makes these enterprise software assets extremely valuable when they are in a position to actually deliver for businesses.

[00:03:25] Sue: Okay, so it's pretty clear that enterprise software is very critical for corporate and for businesses. So what is it that make software companies interesting for investors?

[00:03:35] Dan: I think there's a basic sort of framework. And we'll talk a little bit about each of the elements that's associated with the framework.

But when we look at these assets, we really look at four things, right? We look at the business attractiveness and basically the size and momentum of the business. And largely this is described by some very traditional metrics. Things like recurring revenue or a bit to margin. And this is really where most diligence is in the ability for us to understand the financial numbers and for us to see, how it is that stacks up against their peers. But I think there's a little bit more to it than that. When we talk about some of the other pieces, we talk about things like product and service quality.

So, enterprise software is unusual in the tech field. Strangely that Enterprise, the delivery of quality is actually key toward the valuation of the organization. And when we look at some of the winners in this space, we see that the quality of what they deliver from a software perspective is extraordinarily high, whether that's around a ServiceNow or other organizations in this space that have really won.

Their technology is solid and it does what it needs to do, not just for their particular customers, but for all of their customers. And that makes a big difference.

We also see right to win as being very important in terms of how they go to market is developing. So organizations need to find the right spot where they are actually delivering into the market and they are meeting the market as the customers are buying their software.

So it seems obvious, but a lot of organizations don't do this. You have to sell your software in the way that your customers buy it. And being able to meet the market in that way gives you that right to win. And finally, the ability to scale. So these SaaS assets in particular have to be able to show multi tenancy and be able to serve thousands and thousands of customers efficiently.

That ability to scale is based a lot of times on the core technology that's associated with it, but it's also about your business processes. And how those business processes can play out. Because you don't want to be in a position where growth is really the name of the game, but you have topped out your growth because of your inability to scale.

These are really the four things that we look for around these assets.

[00:05:29] Sue: Thanks Dan. What do you think are typical challenges for investors when they're investing in such enterprise software companies?

[00:05:37] Dan: I think the challenges are myriad, right? So these are not easy assets to unwind in a lot of ways. I think we see a couple of different things that are really important in terms of the challenges and how it is that we help take a look at these in some detail.

One is to understand what the exit plan really looks like around this. And I think it's always a good idea before you begin to invest in an asset to understand what the exit capabilities of that asset really are. And I think we've positioned a very interesting kind of way of thinking about this, as we look at the sphere of assets that are available in enterprise software, we've really placed them into certain categories. Most of the assets that we look at are niche players. So they start small. And these niche players have a particular market that they are, inundating and they are being successful in that market.

And they have ambition. And the question is, what does that ambition look like? There's a couple of key directions that those ambitions can drive. One is that they can begin to be understood as a functional play. So functional play is one that, where the industry is not important, but they are actually enhancing some function that's associated with every organization that kind of looks that way.

Like the best example would be HRIS software, so something like Workday. Where Workday is really focused, has been focused on selling to the HR community, and that HR function then uses that product. The alternative is actually to go the other direction, which is toward the industry. Where the software is really focused on being able to add value to a particular industry.

Whether that industry is banking, or whether that industry is construction, or whatever it is. So, the ability then to double down in that capability is really interesting and can also be a successful play. The interesting story is how you get to the golden quadrant here, the place where you really want these organizations to sit over time.

And that is as platform players. Where they are able to, encompass what are adjacent industries as well as functions and really become sort of ServiceNow, an organization that's truly going to return, many times what its initial investment is. So, heading into that direction has a specific path.

And Simon, I know that you've done some work looking at what that path looks like.

[00:07:46] Simon: Yes, Daniel. We analysed a lot of companies and we identified a clear growth thought, a clear pattern on how companies move in the quadrants you just mentioned. As first, we have the niche players. Undoubtedly, the niche players develop either into function providers or industry solution providers.

As second, we have the function providers. Function providers can move in the next evolution phase to an integrated platform provider. So the golden gray you just mentioned. A good example for that is Salesforce, which started as a function provider with their marketing and CRM solutions. But nowadays it is evolving into a central platform for data management and automatization with a huge cross functional ecosystem.

And last but not least, we have the industry solution provider. Unfortunately, we are not able to find any relevance data. That proves that industry solution provider can become successful integrated platform provider. It seems that the industry solution provider can be successful by themselves, but are not growing out of a specific industry.

That means for an investor, you really need to understand first. where a company is positioned in the different quadrants. What are the growth paths into the future? How does it match the expectation from the management?

How does it match with the growth plan they just laid out? And how does it also match with your own expectation looking into the future?

[00:09:06] Dan: I think it's a great point, Simon, and I think the key thing, when we understand this from an investment perspective, there's a couple of things that we would really be looking for. One assignment set is positioning, right? So do you know where you sit? Do you want to be a function provider? Do you want to be an industry provider?

And what's your pathway toward, additional profitability? If it's to become a platform, then going through the industry route seems unlikely to provide success because there just aren't examples of doing that. So the real interesting question then is, Does the management understand how it is that they are positioned if the management believes that they can be You know a banking service provider and eventually find adjacent sort of industries and eventually become a platform solutions provider I think as an investor you need to be a little bit skeptical of that I think if you're a function provider and you have that view then perhaps But then the question becomes around frame for your investment.

Is it five years? Is it three years? What are you thinking in terms of the time that you're willing to invest in this? And how long do you think the company is going to take to get there? So, the questions that you need to ask as a buyer are around not just positioning, but also the quality of the management team to take you to the position that you think is going to be the most profitable over time.

Not a simple process, but one that we've seen in terms of the software elements that we have looked at. These assets have these things they have a plan, they've been able to show what their, management strategy looks like. And these are the people that we see as being successful and valuable within the context of software.

[00:10:34] Sue: Okay, thank you for your insights. So what we have seen in the industry is a distinction between enterprise software and SAS being thrown out a lot. Could you explain to us what actually changes when a company moves between from a software company to a SAS company?

[00:10:53] Dan: Sure, so it's a great question, Talking about meeting the market certainly meeting the market requires enterprise software organizations to be SaaS organizations now. That is the expectation in terms of how software is going to be delivered from the enterprise. So I think the question now is how is it that these organizations that we see that are producing this software, how are they transitioning?

And sometimes this transition is very convincing in terms of, being able to create multi tenancy, being able to create a real platform for delivery, being able to scale up to thousands of users, and sometimes it's less so. And I think this is where we start to see the technology aspect of what we bring into the game really play large.

Is the question of SaaS washing. Is this organization really a SaaS organization? Or have they just taken their software, put it in AWS, and said it's delivered via the cloud, therefore it's SaaS. I think as we look at these things, we start to see some of the details around the technology that are important.

And this is where I turn to our software developer, and I say, Simon, what are we really looking for?

[00:11:56] Simon: Yeah, what we see in a lot of pitch decks and information memorandums is a lot of different buzzwords on the business side as well as on the technology side.

So something like native cloud or software as a service distribution, etc. And it's quite clear because investors as well as clients love software as a service businesses. We have pay as you use, we have recurring revenue, we have a global market, which is growing with 10 to 15%. But the challenge is actually where is the company in that regards really?

Because the way off delivering software as a service also comes with at least temporary downsides for the provider, which includes a complete different operational setup, which includes a different ecosystem you have to play with, which includes also other infrastructure costs and compliance challenges, security you have to manage.

So there are a lot of different things which a traditional software company didn't have on their radar before they actually become a software service company. And the worst thing which actually can happen is that a company get stuck in between or as an investor that they have no roadmap forward, how they really transform the organization.

So on the one hand side, there might be still have the legacy systems and the legacy complexity from their more or less old days. And they already have the complexity from the new world from software service cloud environment, but they don't have the benefits of those yet. And that is exactly where we need to have a deeper look into as an investor, as well as a partner from our perspective from Alvarez and Marsal how we overcome the different risks, which are including financial, operational, technical ecosystem risks.

[00:13:36] Dan: And these risks are extensive, right? So, so the traditional software distribution model had one of the great virtues is that the incremental cost of delivering the next piece of software was effectively zero. So you had already delivered it but that is no longer the case. There is an incremental cost to each customer that you add.

And you need to find figure out how the unit cost economics against that balance against your profitability targets In addition the sales cycle looks completely different. I certainly, wouldn't run into salesmen very often from a software perspective They come by every five years in order to do an upgrade with me and in the meantime, we pay all of this maintenance but now I, as a software service consumer, have the ability to opt out at the end of my yearly contract, let's say.

So there's more of a high touch kind of play that needs to come from the go to market sales team. And that looks really different. So that transition is not straightforward. And it's all of organization, all the way from the go to market, to the technology, to the operations, to the finance. All of it needs to change in ways that are subtle and not so subtle.

In order to make sure that you can deliver as the market demands that you deliver now as a SaaS provider. That's not an easy call and we spend a lot of time looking at these assets to make sure that they are prepared for that kind of change.

[00:14:52] Sue: You know, there is a lot of confusion when it comes to buzzwords in the enterprise software or the software as a service space. And clearly this confusion can be costly. Could you maybe give us some example questions that an investor can ask in a meeting early on to identify and clarify what buzzwords mean in relation to an investment in the software space?

[00:15:15] Simon: Let me might be start from the technology side before Daniel then might be close from the business perspective. So from the pure technology side, and that is actually the hardest one for the investors, because I believe the investors do not necessarily have technology capabilities by themselves.

So one of the things we are looking at is the big buzzword of multi tenancy. And why is that important? Because it actually decides if you are truly scalable or not. That includes that all the different customers are on the same source code base as well as on the same infrastructure. And that is important for the operations because that means that whenever there is something to improve, that this will impact automatically all customers and can be also solved at the same time for all customers, which is a huge efficiency improvement for operational and internal efficiency.

So how do you figure that actually out? So there are a couple of questions which are still somewhat technical, but the investor could ask:, how many clients actually share one database? How easy is it actually to develop a new feature, which get rolled out to all of your customers at the same time?

How often is actually the update rolled out to all of your different customers? In a previous role, for example, taking SAP, the preparation for an update took weeks, might be even months, depending on the company size. Nowadays, a update should be actually rolled out seamlessly and yourself should be able to activate or deactivate different modules in a second.

So there are huge benefits for the clients, but also especially for your own operations. That goes also into the day to day operational model, which is beyond pure technology perspective, in regards to, okay, how fast can you onboard a customer? In previous time, you always had a week to prepare the environment, or might be even have something to download on the client side, and get the approval by the security officer.

Nowadays, in most cases, you actually just open your browser and you get your environment. A quick customer onboarding. It's just one of many examples why software as a service play out traditional software distribution and why you as an investor should have a double check that this is actually playing out as it's planned to be.

[00:17:30] Dan: Sure. Makes a lot of sense. And look, so there, I think there are a couple of key questions from the business side that we usually sort of throw around as well. Yeah, like my favorite is always: what happens if I want to add 10 more users to the system, right? I think if the answer has to do with anything regarding a contract that is probably not A good SaaS provider, right? If this is about being able to change your pricing on the fly is it about self service?

All this becomes really important in terms of the ability to You know increase the number of users to flex up or flex down In such a way that your customers are happy with the service I also think there's some back end questions that are always really interesting around how it is that sales teams are incented in order to sell SaaS.

One of the real challenges is that if you are looking for big, chunky deals that have annualized revenue this isn't the field that's gonna really generate those kinds of things. SaaS is about upsells. It's about selling something to 10 users, then getting them another 10, then getting them another 10, then getting them another 10.

And if you don't have a sales incentive structure that really makes that work then your salespeople are going to be chasing the wrong things. They're going to be chasing sort of a traditional software sales model in a SaaS world which is unlikely to yield the best results. So I think that, there's a whole series of questions that really identify whether an organization is It's really delivering SaaS.

As part of one of the diligence things that we do for SaaS that we think is really important is to make sure that we understand that it is truly a provider of software as a service. And that increases its value enormously given the way that the market is operating.

[00:19:04] Sue: Thank you so much. There was a lot of information. Which brings us to the question. How does A&M approach investments in the enterprise software and SaaS space in a way that integrates all these different and complex aspects of the sector?

[00:19:18] Dan: Yes, great question. Look, so I think for a different kind of business model, like a SaaS business model, you need a different kind of diligence. And I think looking at the traditional categories of diligence that we see organizations looking for those categories are tough to respect. In the context of enterprise software, especially SaaS software.

So, commercial, operational, IT diligence. In a lot of ways, what we see is that those are not separable in a sort of discrete way. So you can't have a separate technology diligence. If you don't understand how it is that actually plays into the market positioning of the organization and what that means with respect to scalability, both from a sales and from a distribution standpoint.

So, generally, as we look at these things, we begin to see these boundaries becoming less and less clear. And frankly, we don't respect those boundaries. What we do is we look at the asset in its completeness, in its terms of being able to return value. That means understanding about the commercial, the operational.

The technical aspects of it, definitely, but I think more importantly, what it means is understanding there are deep linkages that exist between these things. To make sure that you don't over index against a technology capability, over index against a commercial capability, but you understand what the full end to end change management and evaluation criteria need to look like.

As this as this asset continues to move forward. So, value is found in really understanding the integration that's associated with these. And that's what we try to provide.

[00:20:49] Sue: This has been a very insightful session and we've covered a lot of different topics in this space. Any final thoughts or key takeaways that you would like to share with our

audience, especially those interested in investing in these sectors? Maybe Dan if you want to start.

[00:21:04] Dan: Sure, so I think The key thing that I would want everyone to take away is that this is not a simple sector to uncover.

There's a lot of value that sits here, but there's a lot of value that manifests itself in unpredictable and ways that really require a deep dive. I think the key is to get the right people who really understand, the full spectrum of what's required in order to succeed in this space. and are able to provide you with a view as to how close this investment is toward being world class with respect to any of those.

I think that ability is something that is unusual unpredictable, and something where we really excel. So, I hope that makes sense to people out there. Simon?

[00:21:49] Simon: It might be just giving an outlook for the future as well, because most probably investors not only investing to one company, but also multiple.

And what I see there is also that a lot of investors look into buy and build strategies to acquire companies as a platform for further scale. And I think there is another differentiator between software companies and software as a service companies to other industries, because just adding one and one is not automatically generating you more value.

And that is another aspect where. We need to have a double check what is actually the investor strategy. What is the exit strategy we talked about today in regards to what is the growth path and thinking about what is actually the core of the specific company and how would I like to achieve their goals in regards to technology, operational perspective, etc.

[00:22:42] Sue: Thank you so much for your time, Dan. Thank you so much for your time, Simon. And please stay tuned for the next episode.

Thank you for listening. Make sure to subscribe to the show so you never miss a new episode. Visit our website at alvarezandmarsal.com to learn more and to connect with us.

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