Software-as-a-Service (SaaS): Insights and Issues for Investors

Software-as-a-Service (SaaS)[1] is no longer an emerging technology segment. It's big and getting bigger – and here to stay. The technology research and advisory firm IDC predicts that spending on private cloud services will grow from $9 billion in 2013 to $24 billion in 2016[2] – and public IT cloud services spending will grow from $47 billion in 2013 to $107 billion in 2017.[3]

With 2013 revenue of more than $3 billion[4], Salesforce.com, the largest SaaS pure play, has a market capitalization in excess of $36 billion[5]. While perpetual licensing remains core to legacy software companies' business models, most legacy providers are well into the process of shifting their focus to SaaS. Oracle, for example, saw SaaS revenue grow by 50 percent year over year to more than $1 billion in 2013.[6] As SaaS goes mainstream in an increasing number of market segments and solution categories, it is becoming clear that this is the future of software delivery.

SaaS Benefits

The SaaS model offers significant benefits to customers and providers. Because they don't have to host the software – and it's updated automatically – customers enjoy on-demand application access with lower upfront and ongoing costs. Implementation is faster and switching costs lower. By giving them the flexibility to scale usage rapidly, SaaS helps customers become more agile.

SaaS providers benefit from a model with shorter release cycles, giving them greater flexibility to respond to customer needs. Competitive pricing, shorter sales cycles and lower barriers to sales make SaaS easier to sell than traditional on-premise software. With all users on the same (current) software release, providers don't have the expense of supporting legacy software versions.

The SaaS model also gives providers more predictable revenue and better opportunity to leverage costs, leading to a higher value proposition, as can be seen by these recent multiples.

3Q13 Valuations for SaaS vs. On-Premise Public Software Companies

Sector	EV/Revenue	EV/EBITDA
On-premise software	3.0x	13.5x
SaaS	6.5x	40.6x

Source: Q3 2013 Software Industry Financial Report, Software Equity Group, 2013.

In addition, SaaS providers typically have less complex financial reporting requirements than on-premise software providers.

According to **Mike Mackiewicz**, an A&M Managing Director: “SaaS companies often have simpler and more transparent revenue reporting. They are usually not subject to ASC 985:605 Software - Revenue Recognition, which can be complex and, at times, cause significant differences between cash flow and revenue recognition.”

SaaS Challenges

SaaS solutions are typically less customizable than on-premise software, slowing adoption in categories where customers require unique solutions to map to unique workflows and processes. Concerns about data security, integration with existing systems, data portability and ability to guarantee high availability have also slowed the transition to SaaS – especially in verticals with rigorous data-security and real-time data requirements, such as financial services, public sector and mission-critical manufacturing. As a result, while many enterprises have started to adopt SaaS, most have limited SaaS implementations to remote locations and non-core business units, workflows and functions.

On the SaaS provider side, meanwhile, many of the same things that attract customers to SaaS solutions – low upfront capital investment, automatic software updating – also create lower switching costs, increased vulnerability to pricing pressure, significant unfunded startup and selling costs, and new reporting requirements. **Mike Tamulis**, an A&M Managing Director, commented: “As software providers transition from an on-premise delivery model to SaaS, they may become subject to SSAE 16 - Reporting on Controls of a Service Organization. SSAE 16 (formerly known as SAS 70) requires service organizations that are integral to their customers’ operations to provide comprehensive annual reporting on internal controls.”

In addition, under the SaaS model, service quality and resiliency issues can quickly affect a broad number of customers. SaaS providers must be commercially and operationally adept at supporting and scaling their product to meet customer needs.

SaaS Trends

As demand intensifies due to fundamental drivers like the “bring your own device” (BYOD) movement, smart devices and distributed workforces, SaaS adoption is moving up the food chain. In categories where small and medium-sized businesses (SMBs) have markedly improved IT ROI as a result of implementing SaaS solutions – such as finance and accounting, e-commerce, customer relationship management (CRM) and human capital management (HCM) – enterprise adoption is accelerating.

Other SaaS categories, like data analysis, digital marketing and enterprise content management (ECM), are poised for widespread adoption as security and integration issues are addressed by providers – and as enterprise IT departments become more comfortable with a hybrid on-premise / SaaS approach. Farther out, when legacy systems in categories, including ERP, supply chain management, manufacturing and industry-specific applications become a competitive disadvantage, widespread enterprise adoption of SaaS solutions in these categories will take place.

Time Until Mainstream Adoption by SaaS Category

	Current / near-term adoption (0-2 years)	*Medium-term adoption (2-5 years)*	*Longer-term adoption (5+ years)*
Enterprise	CRM, HCM, finance & accounting, software development & testing, collaboration, e-commerce, sales force automation	Software development & testing, content management, call center, procurement, marketing resource management (MRM), data analysis	ERP, BPM, supply chain management, manufacturing, data security, industry-specific applications, email, office suites, SaaS integration, IT/application management, product lifecycle management
SMB	CRM, HCM, MRM, finance & accounting, software development & testing, office suites, collaboration, e-commerce, email, content management, procurement, call center, sales force automation, data analysis	ERP, BPM, supply chain management, manufacturing, industry-specific applications, data security, SaaS integration,, IT/application management, product lifecycle management	Network as a service, data center as a service

What the Transition to SaaS Means to Investors

The transition of the software business model from perpetual license to SaaS changes the financial risks and opportunities of investing in and operating a software company. An accurate understanding of fundamentals such as renewal rates, customer payback periods and margin profiles is essential. According to **Jimmy Suruki**, an A&M Managing Director: "SaaS providers use varying methodologies to calculate renewal rates, often leading to inconsistent or incomplete results that are not indicative of churn on an annual value basis. This can have a significant impact on valuation."

Ryan Farrell, an A&M Managing Director, adds: "In many transactions, we find that SaaS companies inaccurately calculate gross margins or avoid calculating them altogether. Also, SaaS companies often differ in their treatment of software development costs. Some capitalize them on the balance sheet, while others include them in operating expenses. Interpreting these issues and determining the recurring cost structure and margin profile is critical to understanding the underlying cash flow of the company."

Because SaaS providers often face significant upfront costs – but unlike perpetual-license software providers can't rely on lucrative upfront license fees and implementation projects to fund infrastructure and marketing – the consequences of failure can be pronounced. To succeed, SaaS providers need a highly-defensible market position resulting from superior customer experience, solution customization and / or long-term contracts. According to **Kacey Coles**, an A&M Senior Director: "During periods of transition, we have seen companies misprice SaaS fees or unnecessarily shorten the term of the arrangement. This can significantly impact the long-term value of the customer. In addition, aggressive terms associated with deployment services can have unintended revenue recognition consequences."

Still, for providers that can maintain high renewal rates, streamline delivery and support, and drive higher margins and shorter payback periods, the value potential of SaaS is immense. Leading players in more mature SaaS categories like CRM (e.g., Salesforce) and HCM (e.g., Workday) are proof of this. How other SaaS categories will shake out remains to be seen.

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[1] For this article, "software as a service (SaaS)" will be a placeholder for "anything as a service (XaaS)" and encompass platform as a service (PaaS) and infrastructure as a service (IaaS).

[2] Worldwide Hosted Private Cloud Services 2012-2016 Forecast: New Models for Delivering Infrastructure Services, IDC, 2013.

[3] Worldwide and Regional Public IT Cloud Services 2013-2017 Forecast, IDC, 2013.

[4] Salesforce.com Announces Fiscal 2013 Fourth Quarter and Full Year Results.

[5] Based on Mar. 10, 2014 closing price for stock ticker CRM.

[6] Oracle Doubles Dividend; Cloud Saas Revenues Up 50%, Engineered Systems Up 45%.

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