FINWISE

Connecting great entrepreneurs with visionary investors

14/04/22

SaaS and why it is so popular

- *why investors and startups love SaaS*
- *why SaaS startups need funding*
- *how to analyze them as an investor*

1. <u>Introduction</u>

Even if you are not an insider in the startup space, you have certainly come across the term SaaS ("Software as a Service"). Nowadays we no longer buy the software we need (think of your Microsoft Office package for example) in the local IT shop in a cute little box with a CD-ROM inside. Instead, subscription models have become the standard way to use software and services. In order to continue to use software services you no longer buy the product, but you download the latest update in the cloud and make regular payments (usually monthly or yearly) to continue to use the service.

This business model of providing software as a service instead of selling it as a product has quickly become the worldwide standard how software is being deployed.

In this article we would like to share some insight in SaaS for those with a general interest in this business model, but we also give tips for founders and investors.

In this article we would like to share some insight in SaaS for those with a general interest in this business mode and we give valuable tips for founders and investors. If you are an angel investor currently looking at an investment opportunity, you might want to read section 5 closely for the parameters to look out for in your analysis of a SaaS company. If you are a founder you might better be prepared and know what investors will ask you.

But let's first kick off with the reasons why SaaS is so popular.

2 Why investors and startups love the SaaS model

The reason startups love SaaS models is because hosting software in the cloud allows you to attract clients worldwide without setting up a distribution network while generating a regular and stable income stream.

Investors such as business angels and venture capitalists also adore the business model as it is extremely scalable this way. For every new additional euro, you make on each new client the cost to acquire a new client the cost does not increase by the same euro, but it goes down to almost zero over time.

This combination of rapid scaling potential in combination with increasing profit margins is a model that allows a company to grow exponentially, become very profitable and become very large quickly.

This mix of a predictable revenue streams and extreme scalability potential through reducing and over time even eliminating any marginal distribution cost is why VCs love SaaS companies.

3 Why SaaS companies need investor money?

So, if we now understand why investors and startups love SaaS models, let's move to the reason why SaaS companies actually need investor money.

This all has to do with the cash flow pattern of SaaS companies. As you can imagine, to first develop a software, make sure it works, build a marketing team to make sure people know about you and to build a sales team that can convert leads into clients takes a lot of time, money and effort.

It's also a well-known fact that especially enterprise clients can have long sales cycles. In the meantime, you have to sustain the cost of your staff before you start to generate money with your product. This all leads to a large initial customer acquisition cost to win a client.

When you then eventually win the client, the SaaS revenues that come in only are a little amount each month not a big amount at once. Sometimes you can try to get some upfront payments but usually the revenues are spread over a very long time.

This all means each new customer is cash negative for a while and only becomes cash positive after some time. Therefore, a SaaS company that is growing fast and is successful actually needs a lot of funding. The faster you want to grow, the more funding you need. The initial hole is bigger but also the potential long-term cash flows are also more interesting.

To be attractive for investors, it is you need to already have data on first revenues and cost. Having a working software is not enough.

4 Why SaaS companies need to grow fast

You might ask yourself why SaaS companies want to grow so fast and not gradually when they are digging such a big cash flow hole initially. The answer why you want to grow fast is because SaaS solutions in general are not IP protected or unique in the way hardware, med tech or biotech can be. There is a lower barrier to entry than in some other tech markets.

If you are successful, chances are you that will get competitors who come to the market sooner rather than later. You therefore need to be looking for market domination before others come in. Being first to market makes it easier to take market share before others move in.

Growing fast is of the essence also because once a client has made his choice, the change that he will later shop around again is relatively low because the cost of switching can be high.

Think of your own CRM solution, once you took your pick and you are reasonably happy you really must have an alternative that is much better or much cheaper to change again. You probably invested too much time and effort in order to integrate your CRM into your daily routine and are not likely to switch solution again.

5 How to analyse a SaaS company

If as an investor and you are analyzing a SaaS you want to focus on companies that spend that your money wisely; so, what are the metrics to focus on? Analyzing a SaaS startup is rather an art than a science, but we can give you some basic elements of what to look out for.

5.1 The acronyms

The SaaS textbook has quite a few acronyms:

"ARR"

The first common acronym in SaaS terminology is ARR or Annual Recurring Revenues. This is a forward-looking indicator of the recurring income your startup generates. If you have 10K recurring revenue ("MRR") in January, you can say you have an ARR of 120K. However, if during February you gain an extra client that will result in an additional 5K monthly revenue (MRR) you can now proudly say you have 15K MRR and your ARR will therefore go up to 180K (15x12). As SaaS startups are often valued on the basis of a multiple of their ARR, this extra client therefore immediately boosts the value of your company.

"CLV"

"CAC"

Two other important abbreviations are CLV (Customer Lifetime Value) and CAC (Customer Acquisition Cost). The relationship between both is crucial in analyzing a SaaS startup.

Every investor has his own criteria, but it is clear you want CLV to be a multiple of CAC and you want to be able to recover CAC reasonably fast, for example in max 12 months.

When a startup claims to have a very high customer acquisition efficiency and a low acquisition cost how can you verify this is true? You want to check if the initial customers are representative for the future. Oftentimes, the first new big clients are related to the founders' previous employers and personal network. But maybe these clients are not representative for the future sales as you already had an existing relationship and you had a lot of prior insight and understood their needs already very well.

You need to know the average revenue per account and how it is distributed. You want to avoid that the company dependent on a few big clients that might not be representative for the future growth.

5.2 Understanding the sales cycle, the sales pipeline and how sales is structured

The key word here is '*sales funnel*'. Does the company have a clear funnel and enough data and the right method to move potential customers through the funnel? You want to check if the company has a good sales approach to acquire customers.

The better the data you have (how many leads open your email, how many leads convert after a first call, how many convert to demo, how many demo clients convert to client, etc.) the better it can be used to predict the future;

Usually in the initial phase of the startup, sales is still very founder driven. Founder driven sales is great as you need a founder that is good at sales, but it will become a problem in the future is sales overly depends on the founders.

The founder has a lot on his or her hands and needs to grow the company, build the management team, manage relations with stakeholders, assure funding etc.

The founders need to find strong senior salespeople to grow. Especially enterprise sales takes a lot of experience and hiring the wrong person can set back a startup by up to a year which can be dangerous.

If you want to enter a new market, do not think that market is the same. Often startups underestimate customer acquisition cost in new markets. In their own country they might have already built up some brand value which you do not have abroad, and you need to discount for that. Also, cultural affinity plays a role. Your customer acquisition cost in one country might not be representative for a different country; Selling to people in your own country is different to selling in other countries where you might lack cultural insight in how business is successfully done.

Direct sales vs indirect sales vs website direct sales:

You might want to tap into indirect sales to grow faster using distributors, but it means you give up control. You want to make sure they position your product correctly and give it adequate attention in their portfolio.

Selling directly on your website is ideal but it takes effort to get the process right and often it does not work as automated as you wish.

How much support is needed per client? This impacts the scaling but also is an indication of customer happiness.

Can the company handle big growth? If the sales funnel is efficient but the onboarding is not, the first customer experience will be bad.

It is good to see which KPIs the company uses to track its progress and how structured their approach is. Some basic KPIs are fine, no need to get lost in a jungle of KPIs.

5.3 Understanding Churn

Churn is the rate of lost revenues due to lost customers and is a crucial factor in the sector of a SaaS startup. You want the churn rate to be low. If you lose a lot of clients after a year you are each year making efforts to just replace lost revenue. This will flatten the growth curve.

Ideally you have even negative churn. Negative churn results from increasing the revenue from existing clients by upselling them.

Analyzing churn is ideally done by looking at the revenues from 'cohorts' (years or vintages) so you can see if the revenues from 'year 1 clients' increase or decrease and by how much.

If is of course difficult to analyze churn if the company is still very early stage and not have a lot of history. In that case you can look at pre-churn indicators such as the 'account activation rate'. Imagine your software is used in a department of 100 people, you can analyze how many of those 100 people actually activated your product. It's very different if they all

activated their account or only 20% of them. You have to make sure the account activation rate is high and try to give every single user a positive experience when they do.

Another indicator useful for early stage pre-churn analysis is the number of daily/monthly active users or how many transactions they concluded with your software. Do they use it intensively or only from time to time? The lower the intensity the higher the risk of churn.

6   Conclusion

The two main reasons investors in general and especially VC like SaaS companies is the predictable cash flows (because of subscriptions) and the scalability (increasing profit margins due to declining marginal distribution costs).

You need to grow fast as a SaaS startup in order to become established and to avoid being outrun by competition. To look for funding be prepared and have a good internal sales structure in place. Concentrate on some key KPIs but don't overdo it. As an investor ask the right questions when analyzing the SaaS company.

Some interesting sources if you wish to dig deeper into the world of SaaS:

- Saastr.com (the world's largest community of SaaS executives, founders and entrepreneurs)

- https://www.forentrepreneurs.com/saas/: a top-rated blog by serial entrepreneur David Skok focused on SaaS and other elements of enterprise software.

***