BDO & PITCHBOOK:

# PRIVATE EQUITY'S GROWING APPETITE FOR SAAS

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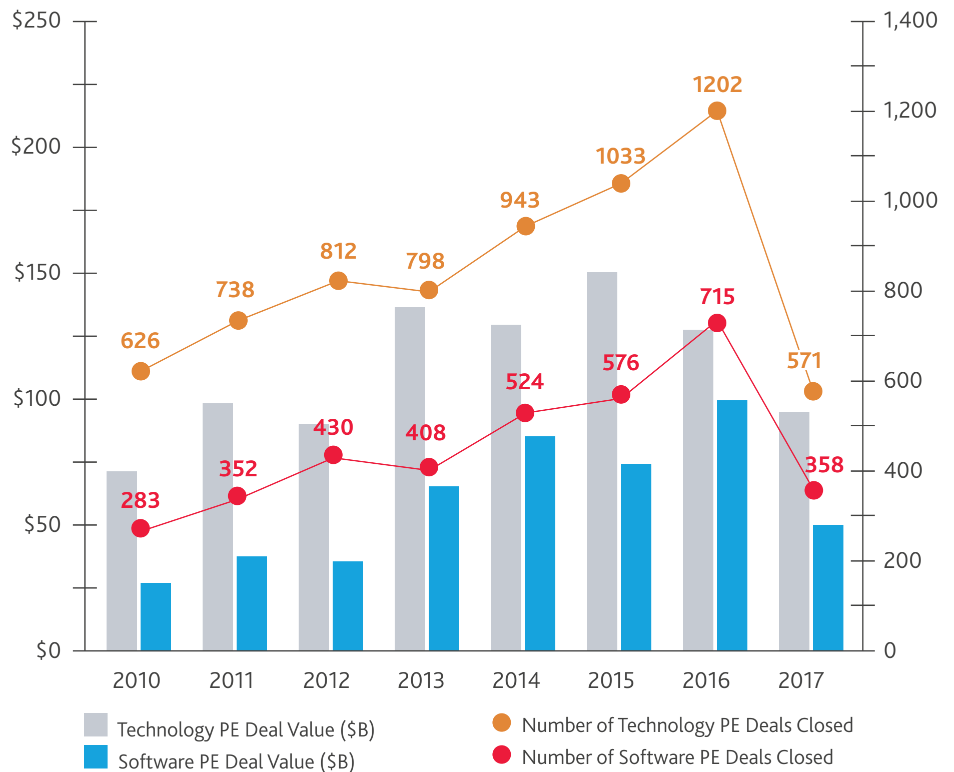
# Private Equity Interest in SaaS Skyrockets

## PE interest in SaaS companies continues to grow, outpacing overall tech deal activity

While recent volatility in the public markets has some investors crying "bubble," private equity's interest in software is quickly gathering momentum. Even as overall tech M&A activity slumped in the first half of the year, PE buyers still announced 571 tech deals over the first six months of 2017— less than the number of deals announced during the same timeframe last year but easily surpassing 2010-2015's mid-year levels. Most of those PE-led transactions were investments in software, which—at 358 deals—made up 62.7 percent of all PE-led tech deals by the end of June.




*Source: PitchBook (as of 6/30/17)*

Behind PE's insatiable appetite for software is an interesting shift in mindset from bottom-line to top-line growth. While growth through consolidation remains a viable strategy, PE shops are increasingly eyeing smaller, younger and arguably riskier targets in the cloud. As recently reported by PitchBook, the number of completed PE deals in the Software-as-a-Service (SaaS) vertical **increased by about 217 percent** between 2010 and 2016 in the US.

Among the most attractive attributes of SaaS companies—and certainly the one that gets most of attention—is their recurring revenue models. In fact, investors have in recent years looked beyond low profit margins if the company has demonstrated rapid growth tied to a steady subscription-based revenue model. The bet is that once a company reaches a more mature state, profit margins will grow.

Private equity buyers have been willing to stomach higher multiples for the best SaaS prospects that are perceived to be more resilient and better positioned for long-term growth than legacy software providers, as enterprise buyers shift from a "cloud first" to a "cloud only" approach. According to research firm IDC, cloud computing spending is expected to grow at upwards of six times the rate of IT spending from 2015 through 2020.

SaaS companies that have been able to meet the so-called **Rule of 40 Percent** have generally been viewed as attractive growth opportunities by investors, even when they have been unprofitable. A common metric used by venture capital investors, the 40 percent rule is calculated by adding the company's growth rate (for example, 60 percent) and its profitability (for example, negative 20 percent). If the resulting sum is 40 percent or higher, the company is viewed as well-managed and more likely to deliver a return on investment. The 40 percent rule—a significant departure from legacy tech and non-tech investment evaluation metrics like EBIDTA, for example—reveals the strength of investor optimism around the growth in the SaaS sector over the long term.

The recent fundraising boom for tech-focused funds indicates continued hunger by private equity investors for access to software and other high-tech investments. Vista Equity Partners, which is focused on high-growth, high valuation software assets, raised $10.6 billion in its latest fund—the biggest tech-focused fund ever, until Softbank stole the title with its $93 billion Vision Fund. The Vision Fund alone nearly meets the total amount of VC deals closed in 2016.

Private equity firms are also edging closer to venture capital-backed territory by recapitalizing startups that are growing long in the tooth. The incidence of such financings, however, is likely to remain relatively low, given the lower probability of such deals being attractive to most private equity firms. Despite that potential deterrent, there are still plenty of prospects for private equity investors to compete for.

And with the latest SaaS IPOs underperforming in the public markets, staying private, or going from public to private, is an increasingly appealing option for high-growth prospects that see the rigors of public company status as a deterrent to innovation. It's a new world for private equity—one where cost-cutting may play a secondary role to scaling up and growing through innovation.

"Private equity investment in the technology industry reflects both reality and optimism: Reality in that the tech sector is responsible for a significant percentage of overall growth in the economy, and optimism that the sector will remain a long-term driver of sustained growth. Nowhere is the impact of that dynamic more apparent than in the Software-as-a-Service sector. With businesses increasingly turning to the cloud to deliver and receive their business solutions, we anticipate demand and innovation to remain high in the foreseeable future."

**Aftab Jamil, assurance partner and leader of the Global Technology practice at BDO**

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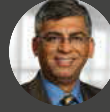

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