VISTA POINT ADVISORS

2022 Founders Report: Software as a Safe Haven

Even as inflation and lingering COVID fears roiled public markets in Q4, a survey of founders conducted by Vista Point Advisors suggests software M&A will maintain momentum in the New Year, helped along by a large proportion of privately held SaaS companies well positioned to choose their own destiny.

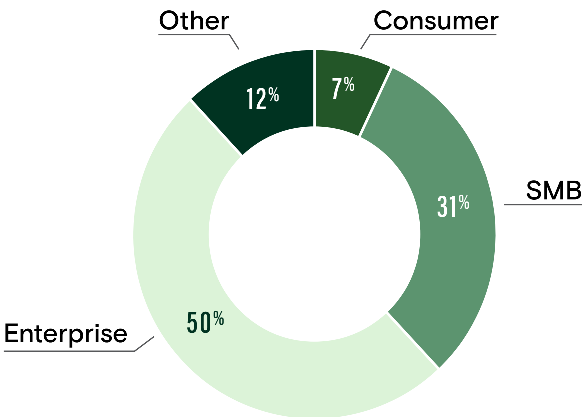
By Michael Lyon, Founder, Vista Point Advisors

According to a survey of 234 C-Level executives at privately held technology and software companies, roughly half are contemplating either a partial or full sale in 2022 (see chart, page 3). This may not represent any grand revelation to most observers. Record high valuations in technology, stepped-up succession planning among baby boomers, and the nearly incessant inquiries from financial sponsors, collectively, have even the most content business owners at least running the numbers on a potential sale. What may surprise some, however, is that the market in 2022 may be even more appealing than it has been over the previous 12 months.

That may seem hard to believe and buyers will likely be even more discerning should the macroeconomic picture change. But for companies showing growth and investing in the right areas to support ARR expansion, there won't be any shortage

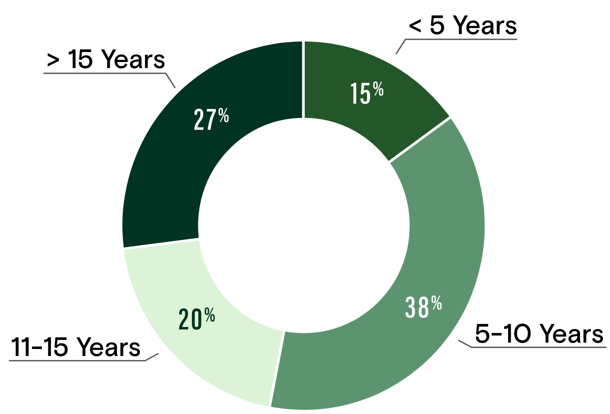
> *For companies showing growth and investing in the right areas to support ARR expansion, there won't be any shortage of suitors.*

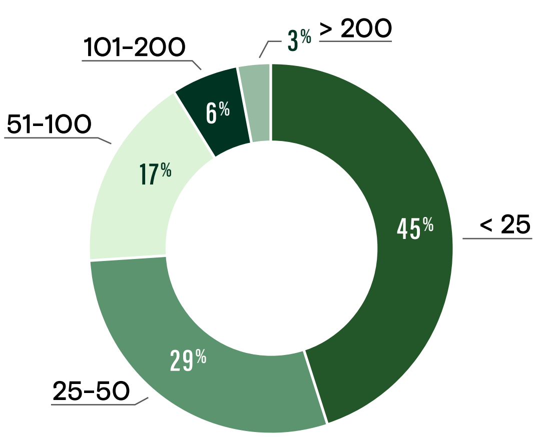
of suitors, particularly as the market begins to open up in the first quarter. To get a sense of seller sentiment heading into 2022, Vista Point Advisors conducted a survey of 234 executives at privately owned technology and SaaS companies. 49% of respondents serve the enterprise market with the remaining balance split between vendors serving small- to mid-sized businesses (31%), consumers (7%), or other end markets (12%). The respondents also tended to come from more mature businesses, with only a small minority (15%) qualifying as a startup less than five years of age. Most respondents were from companies between five and 10 years old or companies founded prior to 2006, pre-dating even the iPhone (39% and 26%, respectively). So these aren't your typical serial, venture-backed entrepreneurs, wired to get in and get out of new opportunities; these are executives who go through a formal sales process once or twice in their careers.



What is your typical customer?

How many years have you been in business?





What is your current employee count?

While a sale may be the ultimate objective–at least for half of the founders polled–growth is very much on the minds of everybody heading into 2022. More than eight out of every 10 respondents, for instance, added headcount last year. Meanwhile, a full 95% of respondents indicated their companies were on pace for positive, year-over-year ARR growth in 2021. And a full quarter of those polled expected to more than double their ARR over 2020. These trends, of course, will bode well for business owners pursuing sale processes within the next 12 months. Interested buyers, however, will scrutinize both where growth is coming from and what companies are doing today to drive recurring revenues. Depending on the type of buyer that business owners are hoping to attract, these aren't trivial considerations.

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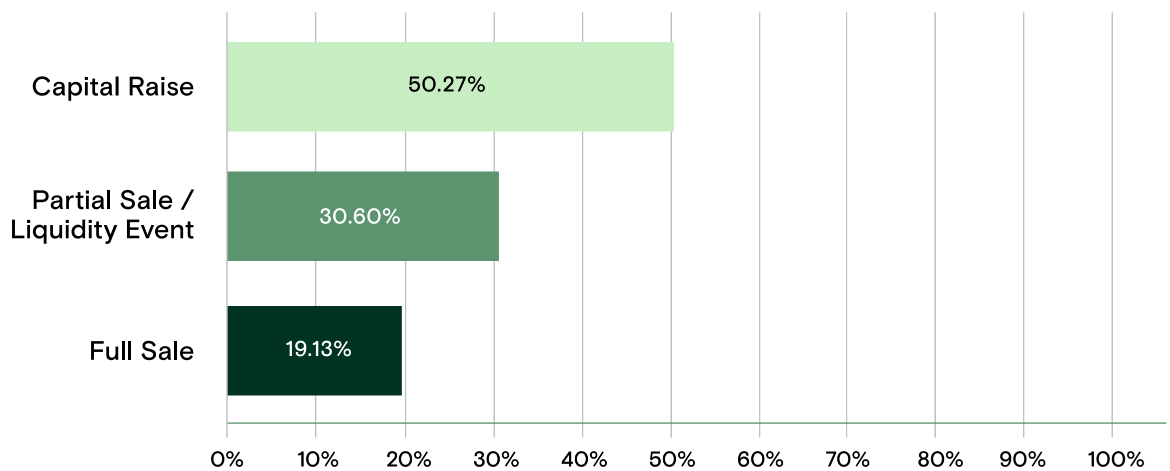
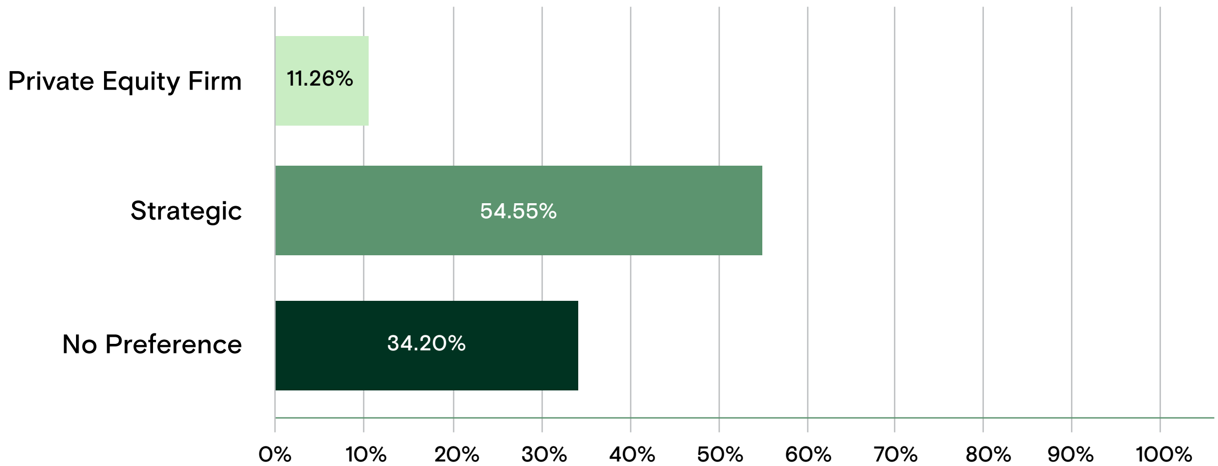
Are you contemplating a sale or capital raise in 2022?



New Twist to the PE vs. Strategic Debate

Most business owners are familiar with the broad generalizations that tend to characterize the appetites of PE and strategic buyers. Strategics, based on the stereotypes, tend to be more aggressive when they're looking to fill a gap in their product or service offering. It's not that they don't care about company fundamentals, but their draw to M&A will generally revolve around cross-selling opportunities and the "synergies" available through plugging a new solution into their sales and marketing engines. While not universal, it only takes one strategic bidder to fit this mold to really energize a sale process. PE buyers, on the other hand, are very focused on operating KPIs – in particular, recurring revenue and retention rates. Strong performance in these areas can allow sponsors to potentially compete with strategics despite the perceived disadvantages. Without the benefit of synergies to augment valuations, for instance, sponsors need to rely on company fundamentals to gain the conviction necessary to pay up when necessary. But sponsors will also be focused on the ways in which they can create added value. For instance, in many cases, sponsors will view an under-optimized salesforce as an attractive source of potential upside, which can be factored into their bids.

Regarding a full or partial sale, which do you prefer (strategic vs. PE)?



The extent to which founders and business owners identified a preference for strategic buyers over private equity is somewhat surprising. Among those polled, 55% expressed a partiality for corporate acquirers, while just 11% said they'd prefer a PE buyer in the event of either a full or partial sale. The remaining balance cited no preference, prioritizing in many cases the potential highest bidder or strategic vision of prospective buyers over anything else.

Historically, strategics haven't always been viewed as the better option. To be sure, in and around Silicon Valley, stories about cultural mismatches tend to get more press than the perfect pairings. But the survey findings may be even more unexpected considering the sample tilts so heavily toward longer-tenured founders, who are generally the target audience for PE sponsors pitching "two bites of the same apple." (And this can often be a very compelling argument for founders who want to accelerate growth before securing a more formal, more rewarding exit down the line).

In recent years, for many in software, a sale to a company like Google or Amazon now represents the ultimate testament of success, even if the odds of piquing their interest are quite slim. It also doesn't hurt that the likes of Google and Amazon can, and often do, pay premiums that obviate the need for any "second" bite of the apple.

Another overlooked factor, however, is that the mystique of the private equity buyer may be eroding to a certain extent. According to the survey, 63% of those polled had received 10 or more inquiries from prospective PE buyers in 2021. Nearly one out of every five respondents, in fact, had received 25 or more inquiries over the past 12 months, while the most in-demand companies can field in excess of 100 calls annually. Compared to 2020, most respondents (47%) estimated that the interest levels are "about the same" as last year, although more than a third (36%) quantified that the inbound solicitations from sponsors have grown by 50% or more. It raises the question of whether these outbound marketing initiatives now so common are helping or hurting sponsors' attempts to differentiate themselves.

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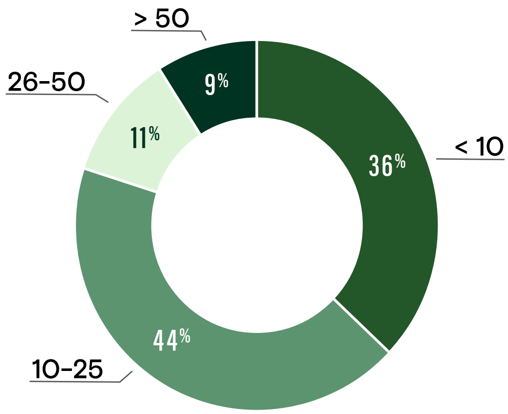
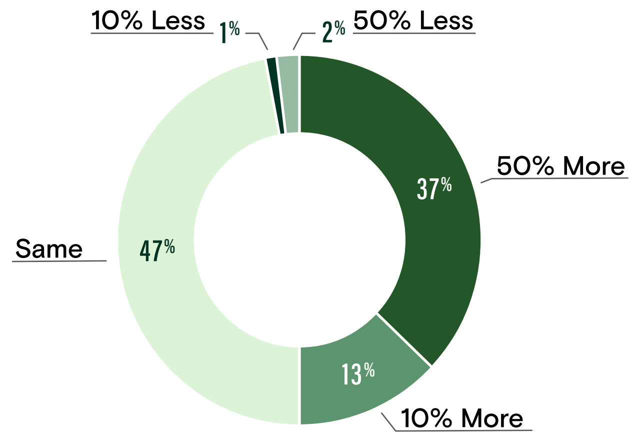


Approximately how many private equity firms have reached out to your company in 2021?

Is this more or less than in 2020?



Again, the conventional wisdom has always held that, short of an IPO, strategic sales traditionally represent the biggest payoffs for would-be sellers. What has changed is that many founders aren't viewing strategics merely as the anticipated highest bidder; they're just as attracted to the opportunity to innovate and gain access to a larger resource base.

This was a point, for instance, that Salesforce.com's President and COO Bret Taylor made during the company's Investor Day presentation in September. He noted that it's not only about picking "the right strategic targets" but making them "more relevant over time" that differentiates the company as a buyer. "If we see an innovative capability outside of our company," he added, "We can actually execute on that." This is a message that resonates with many founders. Contrasted against the other prevailing stereotype, that depicts financial sponsors as the "suits" focused on expense reduction, strategic sales are increasingly seen as the most appealing outcome, even when all else is equal. The gray area, of course, is what to make of the growing population of PE-backed strategics.

On one hand, their appetites very much mirror their public-company peers. They're generally looking to add to their product suite or leverage their investments in sales and marketing through layering complementary services and solutions on top of existing technology and services. On the other hand, the existing valuation of the platform company, coupled with the finite holding period of its owners, tends to create a cap around how high they're willing to go as buyers. This can make deal discussions somewhat fruitless. A rule of thumb, however, is that the smaller the acquiring company, the more influential the sponsor will be in shaping deal discussions, architecting integration plans, and setting the strategy.

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So What Sells?

It’s against this backdrop that the most attractive targets can be just as discriminating as the most discerning buyers. And based on the survey, business leaders are taking steps that will enable them to choose their own destiny. The good news, based on the survey data, is that most can already check the most important box on any due diligence questionnaire, as fewer than 5% of respondents reported having flat or negative ARR.

Buyers, however, aren’t just interested in the rate of growth; they’re also going to parse where it came from and what targets are doing to ensure it is sustainable. To that end, the majority of respondents (61%) cited that revenue and ARR expansion was attributable to new customers utilizing the same products or platforms, which is also where they expect the most future growth to come from over the next 12 to 24 months. The next biggest driver, similarly, was growth stemming from existing clients expanding their usage levels, be it through adding new users to the platform or expanding into new geographies.

These trends, in an auction, would likely appeal to both strategic buyers seeking “sticky” solutions they can drop into their sales and marketing engines and financial buyers seeking a platform they can build upon.

The survey, however, also revealed something of a bias that speaks to the size of the companies in the sample. Only a small percentage of respondents cited either cross-selling efforts (10.8%) or adding new clients on a different platform (6%) as the primary drivers of revenue growth. This likely speaks to the propensity for single-product companies that tend to dot the small- and lower middle-market deal landscape.

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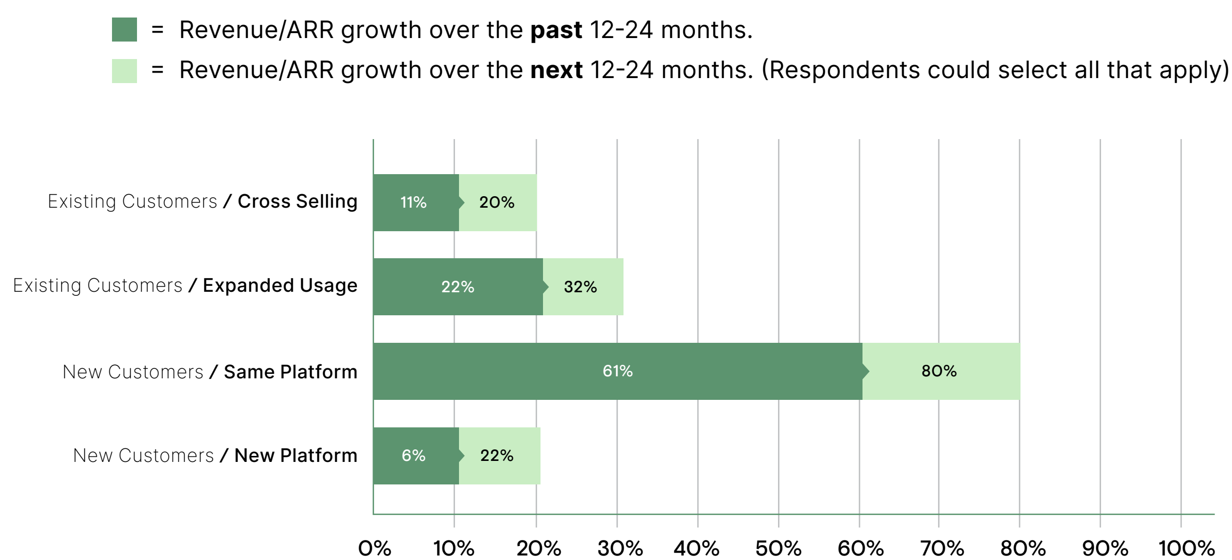
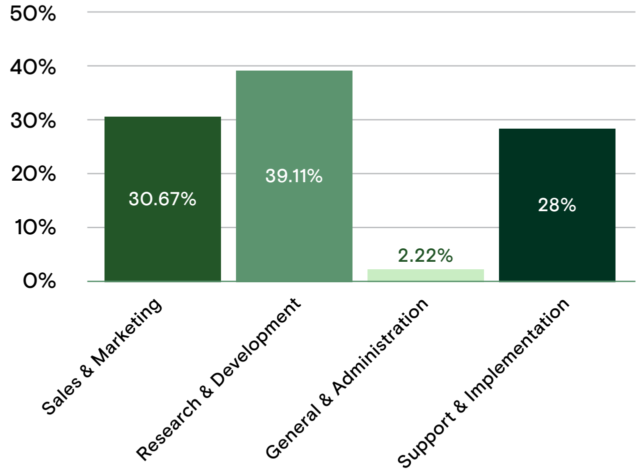


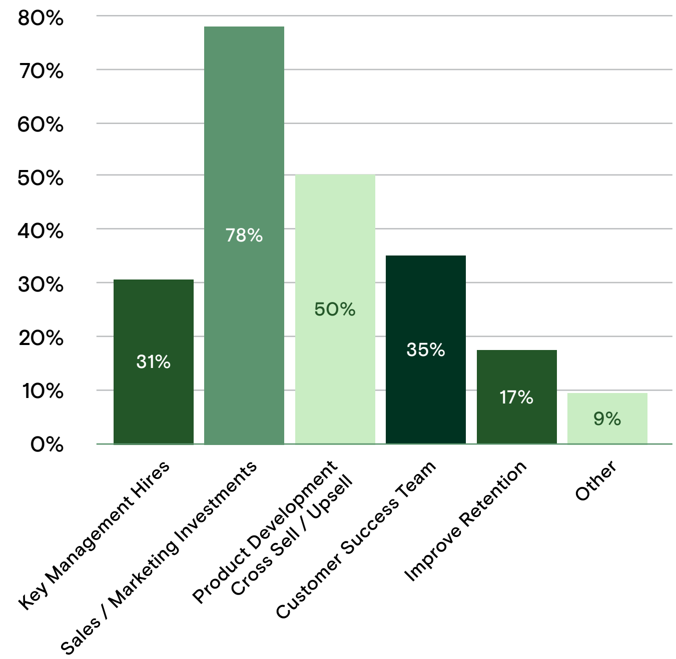
Where did the majority of ARR and revenue growth come from over the past 12 to 24 months and from where do you expect to generate the most growth over the next 12 to 24 months (select all that apply)?

Given that most of the documented top-line growth came from either adding new customers to an existing platform or further monetizing existing customers, one might assume company leaders would be focused on sales and marketing as the capital investment with the biggest payoff. Instead, R&D stood out as the internal function that saw the most employee growth over the past year (cited by 39% of survey respondents). Sales and marketing was the second leading area for employee growth, but was followed closely by investments in support and implementation resources. Again, the findings speak to characteristics that are somewhat unique to this corner of the market. Longer-tenured software companies when they prevail against their heavily marketed, VC-backed peers, do so through being product- and customer-centric and selling sophisticated solutions that meet complex needs.



What was the major functional area of growth in employees during that time?

What will be your key areas of focus in the next 12 months? Select all that apply.



Are Founders Focused on the Right Areas?

To a certain degree, the survey reveals a disconnect between where companies have been committing the most resources (to R&D) and where growth is actually coming from (sales efforts to reach new clients). Yet, respondents overwhelmingly indicated they were keen to augment their sales and marketing organization in the future. This could alternatively be a nod to the sources of growth from the recent past or simply represent the natural progression of the software lifecycle in which product enhancements usually precede a coordinated marketing push. It may also speak to why so many founders are prepared to enter the M&A market in 2022.

Assuming respondents are keen to sell at least a portion of their business next year and strategics represent the most appealing buyers, it raises the question of where to best allocate capital to facilitate these specific outcomes. One of the more auspicious takeaways from the survey was the extent to which business leaders seem to be focused on the right areas that will support buyer interest and likely enhance valuations.

For instance, a large swath of respondents indicated their companies added support and implementation roles, underscoring

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an appreciation for the importance of retention rates among prospective buyers. While these functions saw less growth than R&D according to the responses, they nearly kept pace with those augmenting sales and marketing teams (28% versus 31%, respectively).

When looking ahead, it's clear that more emphasis is being placed on implementation and support, with more than a third (35%) indicating they would be investing in "customer success" programs. While retention seemed to be less of a focus, "improving retention" may also be less pressing given that positive ARR growth rates were so ubiquitous among respondents. The focus on implementation and customer success also directly supports retention. And the attention around these areas, collectively, speaks to the sophistication of executives around what ultimately drives value.

Among PE buyers, growth rates alone may rouse their interest, but retention metrics will instill conviction, as discussed. Among strategic buyers, retention rates offer cues around the extent to which solutions are embedded within client workflows. This can signal whether the product set lends itself to the classic "land and expand" strategy many of the largest acquirers in tech have mastered.

A Bullish Take on 2022?

One of the biggest surprises to come out of the survey was the prevalence of business leaders looking to sell in 2022.

Normally, during periods of rapid growth, entrepreneurs are in their element; even a blockbuster valuation may not have the same appeal as going into work every day, executing upon their vision, and seeing their business reach new heights quarter after quarter. At the same time, while financial and wealth advisors will counsel against timing the market, M&A advisors well know that timing can be everything for a successful sale.

In 2021, there was a flood of companies that raced into the market. This wave, no doubt, was in part related to the end of the pandemic lockdowns; a reaction to the strength and stability of the SaaS sector, which proved out its "safe haven" bona fides in 2020; and seller anxiety related to possible changes to the tax code. It's not hyperbole to say deal volume would've been materially higher were it not for the bottlenecks in the system, in which there weren't enough M&A lawyers or consultants to shepherd transactions through the deal pipeline by year end.

What that means for 2022 is that after this surge of activity works its way through the market – likely by March or April – the relative dearth of dealflow will again give sellers the upper hand.

This is in part why bankers in tech remain so bullish, even as some of the artificial catalysts, such as prospective changes to the tax code, begin to recede into the background. The current seller sentiment, coupled with the fact that so many are investing in the right areas of their business, make us even more optimistic that many sellers could fare even better in 2022 than what proved to be a blowout year for software M&A over the previous 12 months.

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