Understanding Key Valuation Drivers in B2B SaaS

Quantitative Metrics

ARR Growth Rate

Importance: ★★★★★

- Main indicator of future of your business
- Indicates strong product market fit, product differentiation, GTM effectiveness, etc, etc.
- ARR sensitive: Growing 50% YoY at $20m ARR is more difficult than growing 50% at $2m ARR

Definition:

ARR growth rate is the rate at which recurring revenue/subscriptions is growing year over year (usually TTM).

Does not include transactional and one time payments*

Formula:

$$\frac{\textbf{Current Year's ARR – Previous Year's ARR}}{\textbf{Previous Year's ARR}}$$

Valuation Impact	
"Negative" ⟷	"Positive"
< 25%	> 50-100%

**Within reason (see SaaS+ model)*

Gross Revenue Retention (GRR)

Importance: ★★★★★

- High GRR = Sticky, Predictable Revenue
- Indicates high customer satisfaction & loyalty
- More resilient against market fluctuations

Definition:

Gross revenue retention (GRR) is the percentage of recurring revenue retained from existing customers over time.

Does not include expansion/upsells

Formula:

$$\frac{\textbf{Beginning ARR} - \textbf{Lost ARR} - \textbf{Contraction ARR}}{\textbf{Beginning ARR}}$$

Valuation Impact	
"Negative" ⟷	"Positive"
< 70%	> 95%

Highest possible: 100%

Net Revenue Retention (NRR)

Importance: ★★★★★

- NRR > 100% = Even with no new customers, your business will be growing
- Shows how successful the company is at doing "land & expand" – getting more revenue from existing customers through upsells, etc.
- Along with GRR, shows how sticky and predictable revenue is from existing customers
- Also called NDR – Net Dollar Retention

Definition:

Net revenue retention (NRR) is GRR, but also accounts for revenue expansion/upsells from existing customers.

Formula:

$$\frac{\textbf{Beginning ARR + Expansion ARR - Lost ARR – Contraction ARR}}{\textbf{Beginning ARR}}$$

Valuation Impact	
"Negative" ⟷	"Positive"
< 85%	> 110%

EBITDA Margin

Importance: ★★★★☆

- People like profit..
- Key indicator of efficiency of operations and growth.
- Obviously trade off against growth, but perhaps not as "automatic" as Rule of 40 (see next) zealots like to pretend.
- Not the same as Net Income nor Free Cash Flow.

Definition:

Earnings Before Interest, Taxes, Depreciation and Amortization

Formula:

$$\frac{\textbf{Net Income + Interest + Taxes + Depreciation + Amortization}}{\textbf{Total Revenue}}$$

Valuation Impact	
"Negative" ⟷	"Positive"
< 0%	> 30%

Rule of "40"

Importance: ★★☆☆☆

- Usually more of a VC metric
- Captures summary of tradeoff between growth rate and profit
- Not personally convinced that it's as easy to trade profit % into growth %

Definition:

Combination of Percentage Growth Rate and Percentage EBITDA Margin

Formula:

ARR Growth Rate + EBITDA Margin

Valuation Impact	
"Negative" ⟷	**"Positive"**
< 20%	**> 60%**

Gross Margin

Importance: ★★★★☆

- Highlights the core profitability of B2B SaaS companies.
- Solid Gross Margin suggests that there is more profit available for reinvestment.
- High GRR, but low Gross Margin suggests that there are a lot of costs in handling/serving the customer or that there's a lot costs to key APIs/software that is required to serve the customer

Definition:

Profit percentage after deducting the direct costs (COGS) of serving customers.
Does not include costs related to acquiring the customers, etc

Formula:

$$\frac{\textbf{Revenue - COGS}}{\textbf{Revenue}}$$

Valuation Impact	
"Negative" ⟷	"Positive"
< 60%	> 90%

LTV/CAC Ratio

Importance: ★★★☆☆

- High level economic snapshot of S&M expenditure efficiency.
  - High ratio: Good ROI
  - Low ratio: Lower ROI
- Payback time also matters for cash flow!

Definition:

LTV: Lifetime value of a customer
CAC: Cost of acquiring customer

LTV/CAC: How many multiples of the cost of acquiring the customer are we getting over the lifetime

Formula:

$$\frac{\text{Avg ARR per Customer} * \text{Avg Lifetime}}{\text{Total S\&M Spend/New Customers}}$$

Valuation Impact	
"Negative" ⟷	"Positive"
< 2x	> 10x

Magic Number

Importance: ★★★★☆

- High level economic snapshot of S&M expenditure efficiency similar to LTV/CAC, but focused on the all important ARR.
- Also bakes in payback time
  - Magic Number = 1 means you're getting back your whole quarter S&M spend in the following quarter (very good!)
- Usually calculated by Quarter, but you could do it by month or by year – depends a bit on your sales cycle
- General advice:
  - < 0.5 not ready to invest in S&M
  - < 0.75 maybe invest in S&M
  - > 0.75 invest more in S&M.

Definition:

Ratio of new ARR acquired over the S&M spend in the prior quarter/month/year

Formula:

$$\frac{\textbf{Current Qrtr ARR – Prior Qrtr ARR}}{\textbf{Prior Qrtr S\&M}}$$

Valuation Impact	
"Negative" ⟷	"Positive"
< 0.5	> 0.75

Customer Concentration

Importance: ★★★★☆

- High customer concentration is a concern because a small number of large customer churning would materially impact ARR
- Long history of no/low churn of large customers alleviates this
- Longer contracts alleviates this concern
- Being a core part of these larger customers business can alleviate this

Definition:

What percentage of ARR is from the top 10?

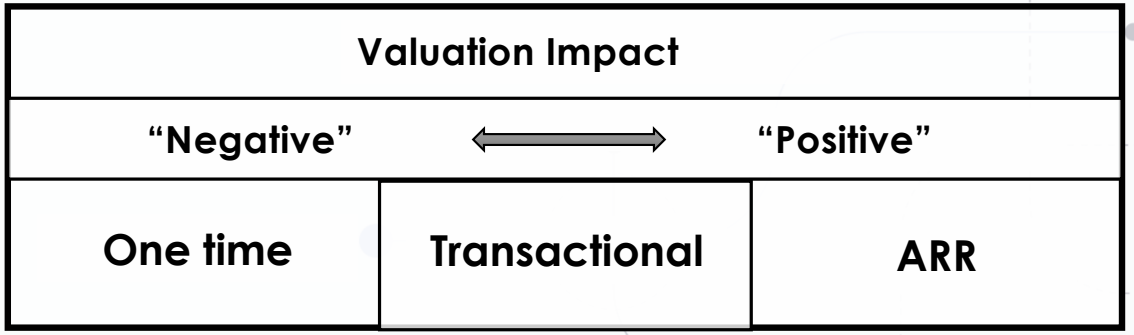
Some also will ask for Top 5 or Top 20.

Valuation Impact	
"Negative" ⟷	**"Positive"**
> 50%	**< 10%**

Qualitative Metrics

Revenue Model

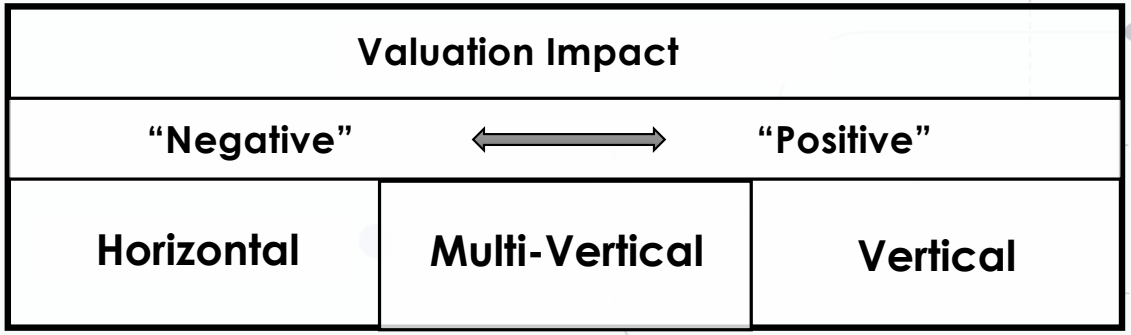
Importance: ☆☆☆☆☆



- One time
  - Classic software licensing. Pretty rare now(?)
- Transactional
  - i.e. Usage based. Examples include charge per email subscriber or SMS message sent. Value of transactional revenue varies ***greatly***! Usually best to bake some usage into subscriptions if you can.
- ARR
  - Much more valuable than anything else. Revenue multiples don't usually exist outside of SaaS (it's eg EBITDA multiples).

Type of SaaS

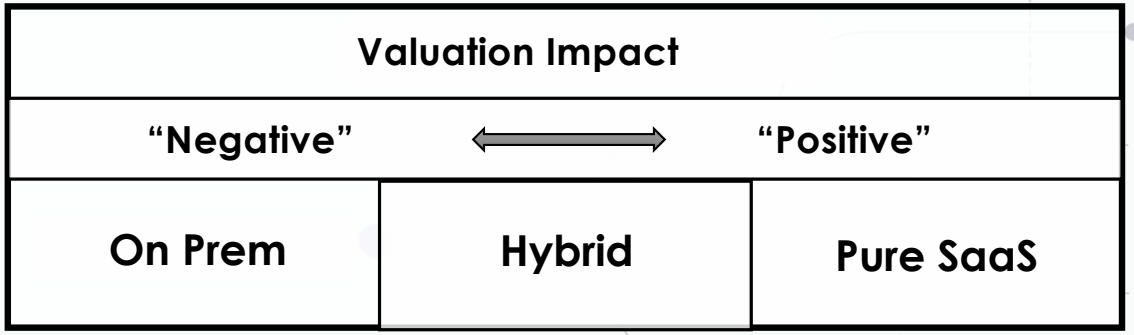
Importance: ★★★★★



- Horizontal
  - Widely used tool, used across functions and industries. Eg eSignature, Calendar Scheduling, Email Marketing. Usually low switching cost.
- Multi-Vertical
  - Can be used across multiple different verticals, but it's a meaty, often mission critical part of a business. Eg CRMs, ATS. Medium switching cost.
- Vertical
  - Used by a specific niche, often to run a large part of their business. Eg Dental SaaS, Auto Shop SaaS, Gym Management Software. Often mission critical and sticky. High or very high switching costs. Sometimes no alternatives.

Delivery Model

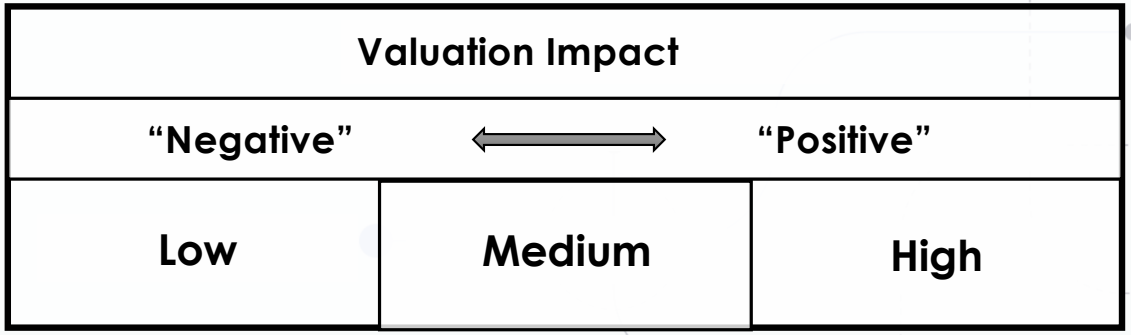
Importance: ★★★★☆



- One Prem(ise)
  - Ie installed on a server controlled (and maybe managed) by the client. Usually either in their data center or on their AWS account.
- Hybrid
  - Half way house – either means some part of the service is provided through SaaS, while some is not (common for companies in transition to SaaS), or that eg a client has their own AWS server, but managed by you.
- Pure SaaS
  - Classic SaaS

Upstream Market Activity

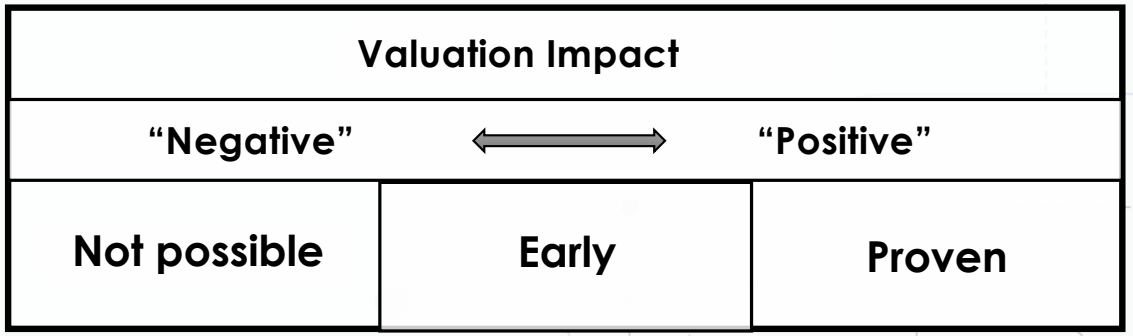
Importance: ★★★★☆



- Low/None
  - Some niches are just simply not on PE's radar, or they're banned from entering. Crypto, porn, gambling, etc is typical here. B2C SaaS fits here too.
- Medium
  - A reasonable amount of activity – ie we're seeing appetite both from medium sized and large PE, but nowhere near a frenzy. As of right now: Performance Marketing, eCom SaaS (after being VERY hot during Covid). These are cyclical.
- High
  - Pure insanity – multiple funds at every stage have "thesis" in the field. Usually means there's no large incumbent or the large incumbent in vulnerable to specialized competitors: A lot of Vertical SaaS falls into this: dental, health, gyms

Enterprise Sales Readiness

Importance: ★★★☆☆



- Not possible
  - Some software just isn't going to have a significant opportunity to sell to large enterprises. It's very rare, but does happen: self serve website builders, self publishing software, personal finance/budgeting tools. A lot of this is B2C or B2Prosumer
- Early
  - Started thinking about selling to larger companies (maybe threw up a Call Us plan) through to some early traction landing larger deals, but maybe not true enterprise. Ad hoc, founder driven sales processes. Maybe ticket sizes are a bit small and pricing hasn't really been nailed down.
- Proven
  - At least beginnings of a full on enterprise sales team SDRs, AEs, etc, etc. Quotas, Pipeline management is a thing.

Customer Satisfaction/NPS

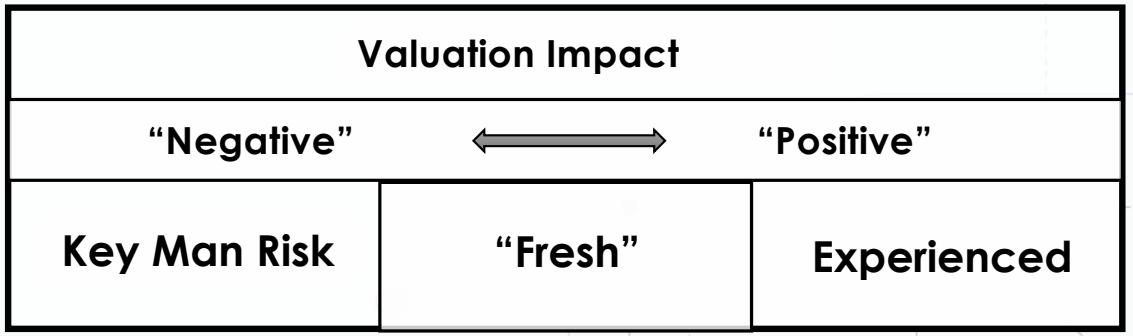
Importance: ★★☆☆☆

Valuation Impact		
"Negative" ⟷		"Positive"
< 30	30-70	70+

- Net Promoter Score
  - Often tracked by PE as it goes up in size (yes they like to quantify things)
  - Higher values usually means lower churn and more likelihood of word of mouth
- Usually other metrics also capture customer satisfaction
  - Though low churn and low NPS is quite risky!

Team

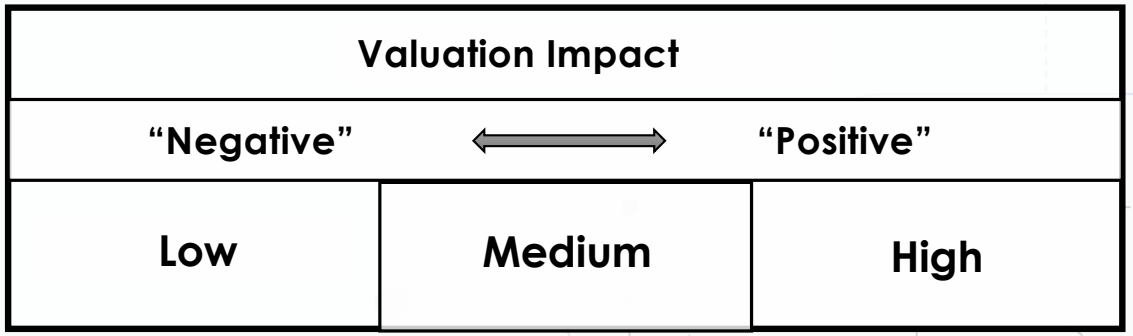
Importance: ★★☆☆☆



- Key Man Risk
  - Some businesses are entirely dependent on the founder or a few key people and if they leave for whatever reason the business will suffer.
- "Fresh"
  - Most of you are here. Starting to put a team together, probably those people are doing what they're doing for the first time. Nothing wrong with this!
- Experienced
  - Been there, done that. Your VP of Sales has taken a similar company from $5-$50m, your CFO helped a company go public (okay maybe that's one too far..)

Growth Potential

Importance: ★★★★☆



- Low
  - Saturated market, no obvious adjacencies to move into. Lots of competition, often low priced (or free/open source) competition. All low hanging fruits have been picked.
- Medium
  - Decent market, no obvious free competitors (but real competitors probably). Started executing on some low hanging fruits. Market overall trending up.
- High
  - Rapidly growing market. Lots of low hanging fruit to pick and adjacencies to move into. Rabid customer demand. JUST NEED MONEY!

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Feel free to reach out if you want a quick valuation of your B2B SaaS