Edison Explains

Software-as-a-service

The COVID-19 pandemic accelerated SaaS adoption

SaaS still growing strongly

Software-as-a-service (SaaS) is a subscription to IT services via the cloud and is available on the internet. SaaS has been around since 2000, but still has high growth potential, as not all companies have made the switch yet while new applications are continuously in development. SaaS solutions are among the fastest-growing segments within the IT sector and, according to Gartner, they were still the largest public cloud services market segment in 2021, representing 37% of the market, or $152bn. Gartner expects end-user spending on public cloud services to increase 20% in 2022 to $495bn, followed by growth of 21% in 2023 towards $600bn. The transition to the cloud has accelerated over the past two years due to the COVID-19 pandemic, as businesses have adapted to the new way of doing business and social dynamics. Another effect of the pandemic is that now 70–80% of B2B decision makers prefer remote human interactions or digital self-service over face-to-face interactions (source: McKinsey). More companies are expected to adopt SaaS solutions for an increasing variety of business functions. According to Gartner, the high growth of public cloud services easily outpaces the expected growth in worldwide IT spending of 4% in 2022 and 5.5% in 2023.

Edison Insight

'Software-as-a-service has been around for several decades, but the pandemic triggered an acceleration of growth and more adoption will drive high double-digit growth over the next few years.' Johan van den Hooven, Edison analyst

A survey by BetterCloud also confirms the ongoing adoption of SaaS, as companies continue their digital transformation journeys. The survey divides the market of SaaS users into three groups. The first represents 15% of the total and consists of SaaS-powered workplaces, which are already almost entirely running on SaaS. These organisations are now 93% SaaS based and this is expected to increase to 97% by 2025. The second group are the workplaces in transition, representing 70% of the total, which use a mix of SaaS and on-premises software. These organisations are 55% SaaS based and this is expected to increase towards 78% by 2025. The third group are the traditional workplaces, representing 15% of the total, which are still primarily using on-premises tools. These organisations are only 8% SaaS based, but this is expected to increase to 27% by 2025. Many (smaller) organisations are still in the early stages of their SaaS adoption journey, but are expected to also switch to a digital workplace in due course.

Why transition to SaaS?

SaaS is replacing the perpetual software licence contract, which includes an ongoing maintenance contract. Perpetual licensing results in a lump-sum payment to acquire the licence, followed by implementation fees and ongoing annual maintenance costs.

Now the market has largely shifted to the subscription SaaS model, revenues are more evenly spread, as subscription fees are paid monthly or annually. Although already going on for many years, we expect the transformation from a perpetual licence model to SaaS to continue, driven by benefits to the customer such as lower upfront costs, higher security levels, up-to-date software and ease of use.

What are the key features of SaaS?

The key features of SaaS software are:

Multi-tenant: all customers use the same software solution. It is not customised, but can be personalised and configured by individual users. The benefit of this to the software developer is that only one version of the software needs to be maintained and software upgrades can be undertaken on an ad-hoc basis. Each upgrade is then made available to all users simultaneously. For the customer, this means more frequent small upgrades, rather than the disruption of larger upgrade projects.

Cloud-based: the software is accessed via browsers or mobile apps, with all data stored in the cloud. This means users can access the software from anywhere, a key benefit for deskless workers and those working from home.

Subscription licensing: rather than buying a perpetual licence upfront with an ongoing maintenance contract, the customer signs up to use the software for a minimum period. For SaaS solutions, this is typically three years, after which the customer can choose to stop using the software. The subscription fee includes the provision of upgrades and support on an ongoing basis. While SaaS companies

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highlight the high recurring revenues this business model provides (typically 80%+), this also requires the provision of high levels of ongoing customer service to ensure customer retention. For companies used to the perpetual licence model, this can represent a significant mind shift and the customer service ethos needs to run through the entire company.

Operational rather than capital cost for customers: as customers do not need to sign up for large perpetual licences and potentially complex installation projects, the decision to use SaaS software shifts from a capital expenditure project to an operational expenditure. Small numbers of employees can sign up to trials before extending to a wider base, if deemed suitable. This can make it easier to sign up new customers, although it also reduces the barriers to entry for competitors.

Business model of SaaS

SaaS has a subscription business model. Contracts are typically for three years with monthly or annual subscription payments. In some cases, SaaS providers earn additional transactional income, based on the volumes processed by their platforms. This can provide additional revenues for the software provider, boosting scale benefits.

IFRS 15 leaves companies some freedom to interpret how they recognise SaaS revenues. Typically, these revenues will be spread out over the contract period, rather than reported in one year, although in some cases the contractual arrangement may lead to the entire subscription amount being recognised upfront. Part of the consultancy revenues (mainly related services) may also be categorised as SaaS revenues. The application of IFRS 15 has affected, for example, the level of SaaS revenues as a percentage of total revenues. This can influence the valuations of companies, which tend to be higher with a higher proportion of SaaS revenues.

How to successfully grow a SaaS business

Successful SaaS software businesses typically focus on growing the number of subscribers as fast as possible, which requires a significant investment in sales and marketing headcount. At the same time, product development is a key investment area, so that software remains competitive and adapts to customer demand for new functionality.

The main focus of SaaS providers is to encourage the adoption of their platform, both signing up new customers and expanding usage within its existing customer base. This will increase the scale of the company at relatively low additional costs.

Typical SaaS valuation

In contrast to the 'lumpy' licence model, cloud-based SaaS leads to higher levels of recurring revenue. With a typical three-year subscription contract, the software supplier has a guaranteed income stream for the contract period, enhancing the predictability of its future results. Well-run SaaS companies typically have recurring revenues of more than 80%, low churn rates and derive EBITDA margins of on average 15–20% or even higher, depending on the scale of the business. As there are also many start-ups in the market, with large investments in their business suppressing profitability, earnings multiples are not the best valuation metric for SaaS players, leaving sales multiples and DCF as the most suitable valuation methods.

Looking at EV/sales multiples, there is a wide range in valuation from 1.5x to around 30x. There seems to be a difference in valuation between US and European players. The typical growth path for US SaaS companies appears to involve investing heavily in sales and marketing to gain market share as fast as possible, with little focus on achieving profitability in the short term, whereas European companies seem to focus more on balanced growth in revenues and profits. Scale is very important in the SaaS environment and this seems the most logical explanation for the difference in valuation between the SaaS players.

SaaS companies covered by Edison include:

CheckIT optimises the performance of people, processes and physical assets with connected digital solutions. The company is headquartered in Cambridge, UK, and has operations centres in Fleet, UK, and Tampa, US.

Esker provides end-to-end SaaS-based document automation solutions, supporting order-to-cash and procure-to-pay processes. In FY21, 55% of revenues were from Europe, 39% from the United States, and the rest from Asia and Australia.

EQS Group is a leading international provider of regulatory technology in the fields of corporate compliance and investor relations. Its products enable corporate clients to fulfil complex national and international disclosure obligations, minimise risks and communicate transparently with stakeholders.

HgCapital Trust is a listed private equity investment company focusing on European software and services businesses, with enterprise values ranging from £100m to more than £10bn.

TIE Kinetix is a Dutch IT software company delivering SaaS solutions to companies, governmental institutions and their suppliers, to help them exchange business documents electronically and simplify supply chain processes.