2023

State of SaaS M&A: Buyers' Perspectives

2nd Annual Survey Results

SEG | Software Equity Group

ABOUT THE RESEARCH

Our second annual online survey was in the field August 1st – 20th, 2023, and garnered responses from 135 participants representing the top private equity investors and strategic buyers in the middle-market software space, and founders/CEOs of B2B software and SaaS companies. Of the buyer/investor respondents, 75% said the number of high-quality assets they're reviewing has decreased, fueling competition and driving valuations higher. As the software landscape evolves, understanding these market dynamics becomes crucial for both sellers and investors alike, to strategically position themselves for success.

About the authors

The survey content and analysis were jointly developed by **Diamond Innabi and Austin Hammer, both Vice Presidents at Software Equity Group**. Diamond has been with the company for nearly a decade, guiding dozens of clients successfully through their sell-side M&A journey, while Austin, who has been a Vice President at Software Equity Group since 2018, has led transactions in a variety of verticals, hosted webinars, and authored numerous thought leadership articles.

Diamond Innabi
Vice President

Austin Hammer
Vice President

Founders and CEOs are exercising caution when considering M&A and liquidity events in the face of ongoing economic uncertainty.

But is their restraint warranted? To cut to the chase: it depends. For software businesses with the right profile (more on that later), there is tremendous opportunity in the current M&A landscape.

To better assess the state of the market, SEG analyzed data from our annual survey of CEOs, private equity investors, and strategic buyers, in addition to our quarterly report and our transactions.

ONE YEAR AGO, we started our 2022 report on M&A trends with a simple observation: the stock market activity was not for the faint of heart. That view led to a much broader inquiry throughout the report into the myriad of dynamics at play and the associated impact on the software M&A market.

IN 2023, WE START WITH AN AGE-OLD ECONOMIC QUESTION:

> **Which comes first, market dynamics impacting market perception or market perception impacting market dynamics?**

While the stock market in 2023 may be relatively less volatile than it was in 2022, there is still plenty of cause for economic unease:

- **Rate hikes took interest rates to their highest point in 22 years**
- **Inflation slowed but remains elevated**
- **In March, three prominent banks failed in the space of less than a week**

This ongoing uncertainty has led many founders and executive teams to conclude the current market is not optimal for an exit. Their caution is understandable, but while the macro-environment provides vital context, it doesn't tell the entire story.

At Software Equity Group, we can only share what we are experiencing, but based on the data we have from the survey, we feel our experience is reflective of the broader market dynamics. We have seen our clients generate more interest and achieve higher valuations than in recent years. However, this comes with a very important caveat: **These clients tend to share a similar profile, one that buyers and investors are increasingly clamoring over.**

TO BETTER UNDERSTAND current market dynamics, we triangulated data from SEG transactions, our quarterly report on public markets and private M&A, and our annual survey of CEOs, private equity investors, and strategic buyers.

Our multidimensional analysis revealed a striking supply-and-demand imbalance. In contrast to widespread perception, buyers and investors are hungry for deals with high-quality companies but see fewer in the market. **The analysis aligns with what we have experienced in our transactions.**

Most buyers and investors feel the deal-making environment is the same or more competitive now than a year ago. A byproduct of this competition is that founders are seeing increased inbound interest from buyers and investors.

It appears there is a mass perception that now is a "bad time" to sell, which may be contributing to a shortage of high-quality companies on the market.

> **Paired with a strong demand for high-quality assets, this scenario creates a perfect storm for a competitive deal-making environment.**

In this report, we share our findings, including what buyers and investors are looking for, how valuations have been impacted, and what companies can do to position themselves going forward.

Details are available in the report, but the crux of our insights is this: **For companies with profitable growth and strong retention, this may, in fact, be the ideal time to explore a liquidity event.**

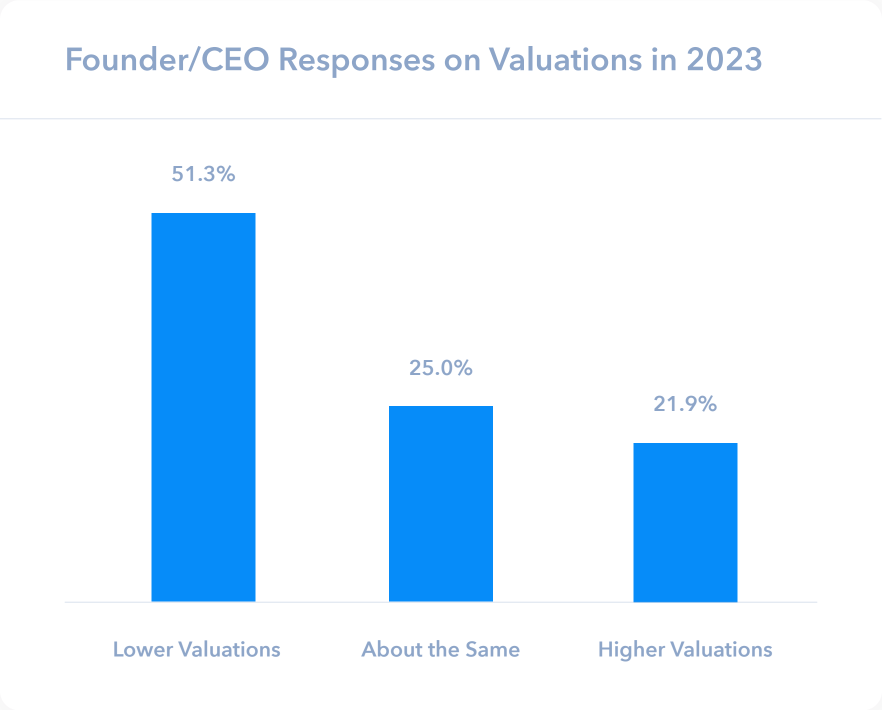
TAKEAWAY #1

Cautious CEOs Are Holding Off On Going To Market

Against a volatile economic backdrop that has included inflation, high interest rates, layoffs, and geopolitical instability, executives and founders may be concerned about the potential for a recession.

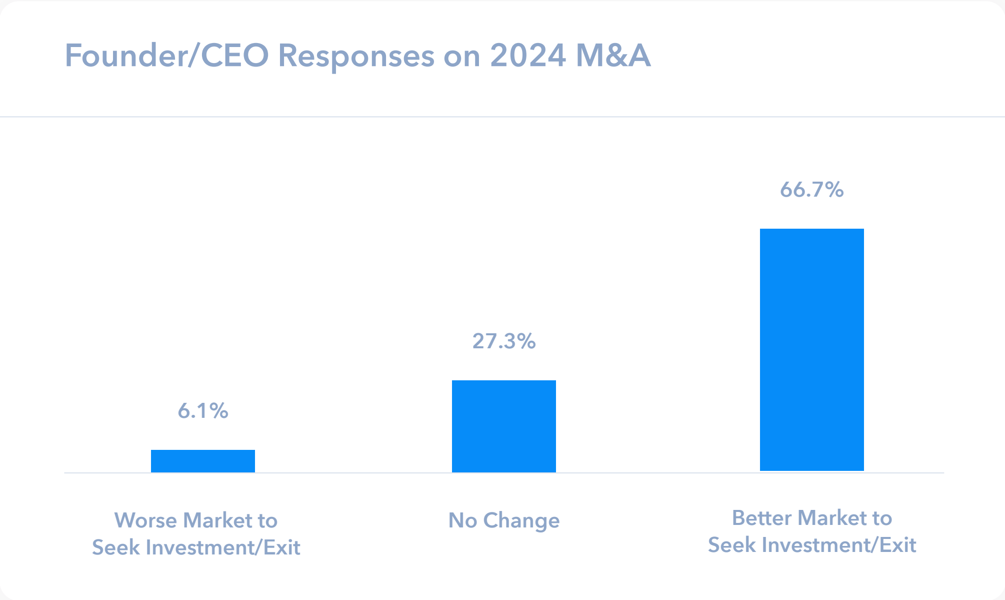
Not surprisingly, the macroeconomic environment has colored their perceptions of the SaaS M&A market. **Seventy-eight percent believe valuations are the same or lower than last year, and over two-thirds believe the market will improve in the coming years.** As a result, many are waiting to explore and see what the future holds before going to market.

In 2023, how do you think SaaS M&A valuations have changed relative to 2022?



However, this same group of CEOs communicated that they are hearing more from investors and buyers in 2023. Despite the gloomy view of the market, 95% of CEOs are seeing as much or more inbound interest than last year.

Relative to the first half of 2023, how do you perceive the M&A market will change going into 2024?



This apparent paradox suggests that because sellers have adopted a "wait and see" approach amidst market volatility, the result has been a shortage of high-quality M&A deals. When combined with the record amount of capital available for software and SaaS M&A, wthis creates a fascinating and highly competitive market dynamic.

It's quite fascinating to see the perspectives of CEOs regarding the market. They likely have formed their opinions by drawing insights from the public market news. Surprisingly, more than half of CEOs believe valuations have declined, whereas, in actuality (and in SEG's real-world experience), valuations have risen for companies with mission critical offerings, high retention, and profitable growth.

- Diamond Innabi, SEG

TAKEAWAY #2

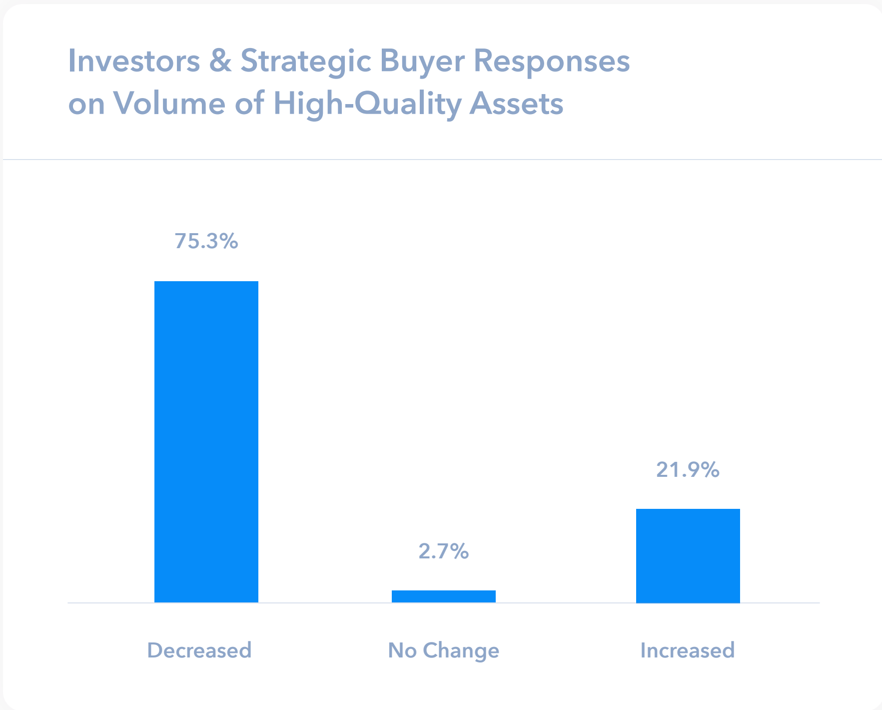
Buyers And Investors Face Shortage Of Opportunities

In contrast to the CEOs' viewpoint, buyers and investors are finding that the competition is holding steady or getting stronger. They are eager to do deals with high-quality businesses, but there are not as many opportunities available as in 2022.

When asked how the market has changed since 2022, 75% percent of private equity investors say the volume of high-quality SaaS companies on the market has decreased, while 85% see the same or increased amounts of competition for assets.

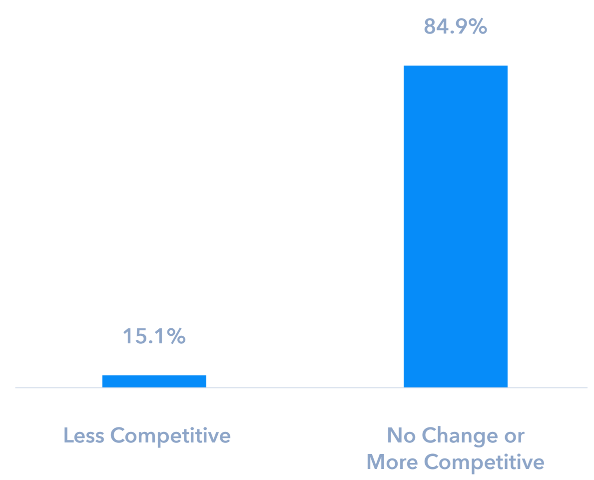
Meanwhile, 66.7% of strategics say they have seen no change or a decrease in the volume of high-quality SaaS companies in the market over the past year. This supports the idea that high-quality M&A opportunities are scarce in 2023 and high-quality businesses that pursue a liquidity event receive outsized interest from buyers and investors.

In 2023, how was the volume of high-quality SaaS companies your company is reviewing changed relative to 2022?



For high-quality SaaS companies you are bidding on in 2023, how competitive is the current deal-making environment relative to 2022?

Investors & Strategic Buyer Responses on Competition for High-Quality Assets



SEG's experience bears this out. We have also seen **118% increase in Indications of Interest (IOIs) in 2022 TTM compared to 2021, known as the peak of software public and M&A markets.**

With demand for high-quality assets outpacing supply, companies with the right profile can benefit from scarcity in the market and increased competition. However, it is important to note there are specific criteria buyers and investors use to define high-quality opportunities, which are constantly evolving in response to market dynamics.

Buyers and investors are strongly focused on three specific factors: growth, retention, and profitability

In line with SEG's experiences, the buyer community is encountering equal or even heightened competition. This is likely a direct impact of the lack of supply of high-quality businesses in market. SEG has seen a substantial increase in bids for our client's companies this year compared to last which directly reflects the competitive environment felt by the buyer community.

- Austin Hammer, SEG

TAKEAWAY #3

Growth, Retention, And Profitability Are Key

Given the uncertainty in the macro markets over the last 18 months, it is not surprising that buyers have become more risk-averse, and the profile of a highly desirable asset has shifted.

So, what is the profile they are seeking?

> **For today's buyers and investors, high-quality assets possess profitable growth with high retention.**

Notably, over 75% of both private equity investors and strategic buyers placed revenue growth among the top three most crucial factors for consideration. Retention is also crucial, with investors placing gross retention as the second-most important metric after growth.

Nevertheless, while revenue growth and retention are weighted strongly, there is little interest in businesses burning significant cash. In 2020 and 2021, the high-burn, growth-at-all-cost model was considered an attractive asset. In 2023, the story has now changed.

Qualitative responses from investors and buyers alike indicate profitability and the Rule of 40 are deal breakers or makers.

Many buyers and investors describe profitability as a binary dynamic in M&A today. Breakeven/profitable is a "go," while high cash burn is a "no-go." This idea is reflected by the strong presence of profitability in the survey's free response portion. (Growth and retention are also mentioned frequently.)

Fascinatingly, in contrast to the responses from buyers and investors, 64% of CEOs believe profitability is of low importance to buyers and investors, and 61% percent think retention is of low importance to buyers.

An astonishing 25% don't even track retention!

These numbers further reinforce the perception gap that exists in the market today. Not only is there a lack of visibility into the M&A opportunity that high-quality companies have, but there is also a disconnect regarding what an attractive software company looks like in the eyes of buyers and investors. Many understand growth is important, but many more may be surprised by the importance buyers and investors place on profitability and retention.

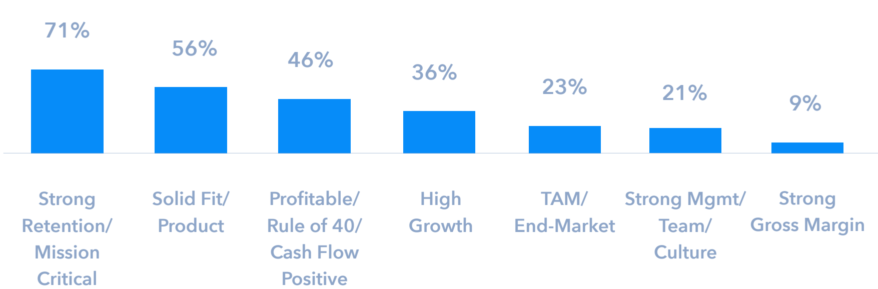
It is also worth noting that 56% talked about fit and product/technology. This is not surprising as we know the ultimate value of any software company lies in its technology, so it's a key consideration, particularly among strategics, who analyze M&A through product lens.

The confluence of changes in the macro environment, buyer and investor priorities, and availability will, of course, affect valuations.

The question is, how?

In 2023, how was the volume of high-quality SaaS companies your company is reviewing changed relative to 2022?

Investors & Strategic Buyer Responses on Volume of High-Quality Assets



> **From my standpoint, this was particularly intriguing. While we had anticipated that factors such as customer retention and strong product would be important to buyers, seeing nearly 50% of buyers consider profitability and cash flow important when assessing a company's attractiveness was a reassuring validation of our real-world experiences. In 2023, we've witnessed the "growth at all costs" model fall out of favor quickly, seeing it noted by almost half of all buyers, confirming our belief in this new trend.**
>
> **- Diamond Innabi,** SEG

TAKEAWAY #4

High-Quality Assets Are Demanding Premium Valuations

As we stated up front, the current market represents a classic supply and demand dynamic. When the supply of a good decreases, and the demand for said good stays the same or increases, its price is expected to increase.

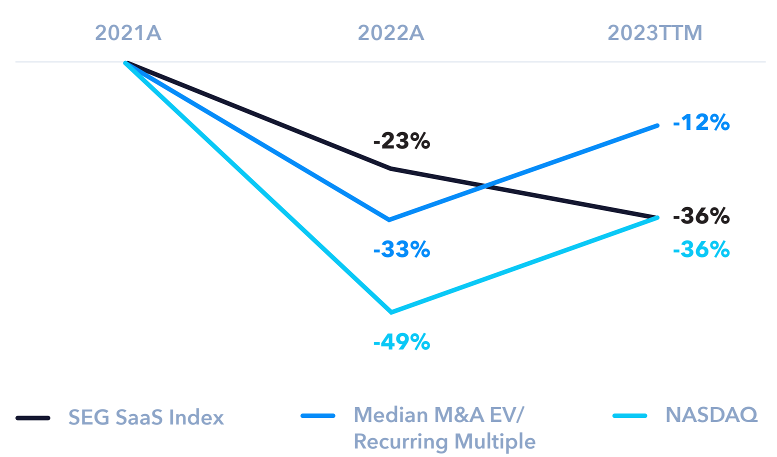
> **If the above is to be true for software M&A, where is the data that supports it?**

The answer is hard to find in the public markets. The share prices of public SaaS companies in the SEG SaaS Index have rebounded this year but are still down roughly 36% from COVID-level peaks. The Nasdaq has sharply rebounded from 2022 lows, due to the "Magnificent 7" companies and excitement over artificial intelligence. Most notably, valuations in M&A deals have decreased by 36% since 2021.

Given this environment, can private SaaS companies fare any better?

For starters, according to the survey, 41% of investors have seen either no change or an increase in valuations since 2022 for the high-quality assets they are targeting.

General Market Performance
Compared to 2021

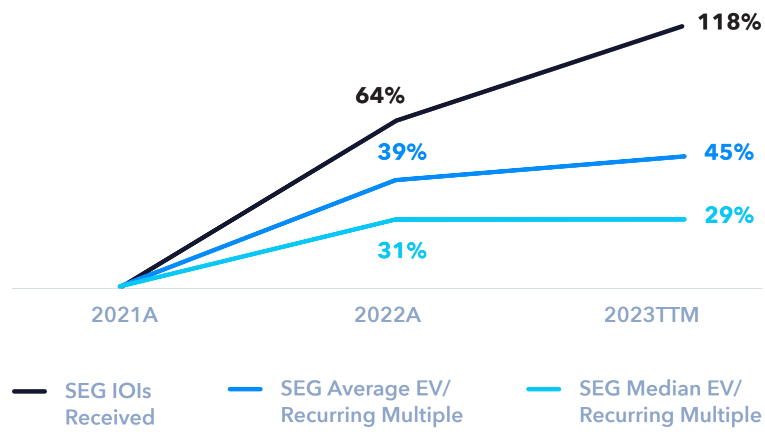


Peeling back the onion even more, our experience at SEG helps fill out the picture. As we have alluded to, the style of business sought after today differs from the one that was in vogue in the previous market cycle. The previous cycle placed a strong emphasis on the growth-at-all-costs model. However, sustainable, durable, and mission-critical software businesses are driving demand today.

When comparing the median and average EV/ARR multiple of SEG clients in the trailing twelve months (TTM) against the record-breaking 2021 market, we see that multiples have increased 29% and 45%, respectively. From our experience, there remains a tremendous amount of demand and excitement for software M&A—even more so than in 2020 (from a valuation standpoint).

SEG's clients align with the preferences of discerning buyers and investors who value characteristics such as durability, mission-criticality, strong customer retention, and profitability in software businesses. For these companies, this is where we really see the paradigm shift in the markets. While valuations for cash-burning businesses have placed downward pressure on broader M&A multiples, the subset of high-quality businesses receive average EV/Recurring multiples nearly 1.5x higher than in 2021. As another intriguing market dynamic to note, this further supports what we would expect to see based on the survey results.

SEG Metrics
Compared to 2021



Buyers and investors are looking for sticky, durable software businesses with a certain financial profile. For companies that fit that description, there is a competitive M&A environment that is driving robust valuations

- Austin Hammer, SEG

Given the current state of the market, including valuations and trending company metrics,

SaaS company founders may have more options than they realize.

IN THE FACE OF ECONOMIC UNCERTAINTY

There Is Good News For SaaS Companies

It is easy to understand why CEOs are cautious right now, and many are right to be. The landscape has shifted from where it was a few years ago, with buyer and investor priorities shifting as well. It is clear, however, that the deficit of profitably growing assets on the market is working in favor of sellers. This is due to increasing competition for highly sought-after software companies that display strong revenue growth and retention.

One thing everyone agrees on: higher valuations lie ahead.

> **The majority of buyers, investors, and CEOs believe valuations will increase in 2024.**

Since an M&A process typically takes 6 to 9 months, this may be the perfect time for businesses that fit the profile described in this report to pursue a liquidity event.

For founders whose companies are burning cash or have lower gross retention, this is an ideal time to assess the lifecycle stage of their companies and focus on opportunities to increase efficiency. Whether these founders continue their current path and adjust their timeframe for M&A or choose to focus on optimizing for profitability, retention, and growth, they can make informed decisions based on a clear, objective view of the current market landscape.

Are You Ready to Seize the Moment?

At SEG, we've cracked the code to success in middle-market software M&A, and it all starts with understanding what buyers truly want.

Our track record speaks volumes: an impressive **85% first-pass success rate** since 2020. We don't just take on clients; we partner with those in whom we genuinely believe we can secure the best deals.

But even if you are not considering an exit today, our informal guidance will help you focus on the qualitative and quantitative factors that will position you to drive higher multiples and achieve the deal of your dreams down the road.

Request a strategic assessment today and let's start crafting your success story.

Explore Your Options

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