DURA
S O F T W A R E

Maximizing Exit Value for Small Software Companies

$2mm to $10mm Annual Revenue

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Author's Note

Please note that this document was created prior to the crisis brought by the Coronavirus in early 2020. Ratios and numbers are changing daily because of that. However, we've decided to publish this as the concepts here are valid no matter the state of the economy.

About Dura Software

We are an acquirer and operator of small software companies ($2mm to $15mm in annual recurring revenue). In the past years, we've evaluated thousands of companies and spoken to hundreds of sellers. We've learned a great deal about how sellers can get the most for their business by making certain changes to the company that optimizes its value to an acquirer. This document shares the current state of the small software company M&A (early 2020) and factors that affect where companies will land in the common transaction price range.

About this Document

As an acquirer, we often talk to sellers of small software companies ($2mm to $15mm in annual recurring revenue) who talk to their neighbor who tells them: "Software businesses are selling for 5x times revenue." This helpful neighbor often has read an article in TechCrunch about multiples for fast-growing Silicon Valley startups or mistakenly used public market multiples to give this advice. Many sellers then quickly discover their neighbor didn't know what they're talking about.

Other times, many sellers of companies engage professionals like business brokers or investment bankers to represent them. To win business, some of these professionals will even exaggerate multiples as they attempt to sell their services. This adds to the confusion in the marketplace as well since only big splashy sales numbers get publicized by brokers. Rarely do you hear about the business sales that happen every day.

State of the Market in Small Software M&A $2mm to $10mm ARR

As of early 2020, the market has broken into four distinct segments for small software companies approaching a sale:

Segment	Distressed	Underperforming	Healthy	"Rocketship"
Status	Forced to sell due to running out of cash; external factors like health or divorce	Barely breaking even or low EBITDA/growth combo	Don't need to sell but will for the "right price."	Greater than the "rule of 40" (EBITDA + growth YoY).
Operations	Need heavy lifting to get the business running well	Needs some work to get on the right track but not tremendous amount	Slow growth (<30% annually), very profitable EBITDA, running well and stable; small market.	Running very well. Indications of product-market fit in a large market.
Trading Range	0x-1.25x ARR	1x-2.25x ARR	2.00x-4x ARR	>4x-10x ARR or more
Acquirers	Turnaround funds, turnaround companies, "strip down and burn the cigar" style buyers	Micro/Nano PE, Financial buyers, Holdcos	Financial buyers, PE bolt-ons, Vertical consolidators	Strategics, Venture Capital (VC), PE Bolt-ons

Notice that we have listed a trading range for each segment in terms of annual recurring revenue (ARR). These ranges are pretty large. For example, for a distressed company with $2mm in annual revenue could be valued anywhere from $2.5mm to nothing. Where a company lands in that range depends on a large number of factors tied to how the business has been run and built.

Note that these ranges are rough estimations where the majority of transactions are happening. There will always be exceptions but our opinion is they are few and far between.

To reach the high-end of those ranges listed, a business needs to have the characteristics to match. If things are off in one or more of these areas, that business is seen as having flaws compared to a "perfect" business, which reduces the value that an acquirer will offer when buying the business.

One way to roughly understand how a buyer will value your business is to look at that range as a guideline, then evaluate it using the same things that an acquirer considers.

From an acquirer's perspective, they consider the business in terms of transferable value. What quality of business will come to the acquirer after they purchase it?

The next sections will review those factors in detail and how they affect the acquirer's ability to turn a profit after buying a small software business. Sellers can use these as a guide to not only improve their business, but to improve the amount they expect to be paid at the time of sale.

Factors that Impact Small Software Business Value

SaaS versus License versus Usage-base

The way the business model works for a software company is important. Many legacy companies in the software space use a classic license plus maintenance fee model. For many acquirers, this is a tougher sell since the buyer needs to bet that license sales volumes will continue in order to maintain historical revenue numbers. Only a portion of the annual revenue comes from maintenance or support fees. Licensing revenue is lumpier and harder to predict, hence you will get more surprises and of greater magnitude. This lowers intrinsic value of the business.

Other software companies charge on a consumption model. This is also less desirable for acquirers since there is a risk that demand can change

dynamically. When customers come in they can just as easily leave in a pay-for-what-you-eat pricing structure.

If an acquirer is modeling the future cash flow of consumption or license model, it's very easy for a small software company to quickly shift from cash flow positive to negative. This reduces the price an acquirer can pay and still maintain a margin of safety.

SaaS on the other hand, produces a more predictable recurring revenue stream. To lose that revenue, a software company needs to lose its customers entirely. Customer churn is a predictable event based on assumptions of past performance. This is why SaaS models receive higher valuations than other revenue models and are the gold standard in commanding higher multiples.

Customer Concentration

Many small software companies, especially in B2B, are subject to a problem called customer concentration. This is a situation where a small percentage of customers represent a large percentage of the total revenue.

To an acquirer, customer concentration creates substantial risk to the revenue (and profit) streams from the software business. If a single customer out of a hundred, for example, represented 15% of the total revenue, losing that one customer could easily push the company from EBITDA positive to unprofitable.

This risk is often overlooked by company owners who may have a long-standing relationship with a client or possess information on them that isn't represented in financial statements. Thus, sellers are prone to seeing their customer base more positively than in reality. Acquirers of these software companies will discount valuations to reflect the increased risk from customer concentration.

Fortunately for sellers, customer concentration risk is an easy metric to track. A reasonable test is to see how much of the company revenue comes from the top 20 percent of customers. If it's more than half, a company has a customer concentration problem and a seller should work to diversify their customer base to increase exit value.

Geographic Limitations

The highest EBITDA or revenue multiples are typically paid by United States buyers targeting domestic companies. If a US buyer considers an overseas company, the overall cultural friction is higher. This buyer needs to learn foreign laws, hire foreign lawyers, deal with currency issues, different work cultures, time zones, and travel visas just to name a few. US-based companies are easier and therefore can command full multiples at the time of exit.

There are exceptions to this. For example, self-service SaaS is much easier to transfer across borders than a software product with a direct sales model. If an acquirer can easily turn the target into a US-based and focused Saas business, the business will have more transferable value. For a seller, maximizing value can come with running the business in line with US accounting principles, metrics, laws, and other common practices.

Technical Debt

Technical debt is a part of every software business, but in many small software companies, it presents a large challenge. Many small companies cut corners to get the product out the door or to compensate for a lack of expertise on the development teams. In the worst case, a company can be technologically years behind where it needs to be to compete in the market.

Technical debt becomes very impactful on the valuation when the company hits hard times. In those cases, the first thing to go is development spending so the company can stay afloat. This can create problems as simple as getting behind on supporting operating system versions or other dependencies. In some cases, entire waves of computing can be missed like having a client-server solution when cloud-based systems are the norm.

To illustrate, imagine a small software company with $2mm in annual revenue that is running well at 20% EBITDA. However, if the acquirer needs to add two developers to the team for two years to clean up technical debt, that can put a large dent in earnings. If these developers are total of $100k each in annual

compensation, it would take this hypothetical small company from 20% EBITDA (400k) to 10% EBITDA (200k) for two years. That's a significant impact on the profitability and resulting value of the company for an acquirer.

The first way for a seller to avoid technical debt is to minimize it in the first place. The second and more difficult path is to reinvest in the business to keep it current. Both require discipline and time from the seller to accomplish.

Revenue Growth Rate

The difference in valuation between a company growing a few percentage points a month versus one shrinking several percent a month is greater than you would guess.

Consider three different companies. All start at $100 in revenue the first year. One is shrinking by 10% each year, another staying flat with no growth and the last is growing by 10% a year.

COMPANY "GROWING"					
Growth YoY	10%	10%	10%	10%	10%
Month	1	2	3	4	5
Revenue	$100	$110	$121	$133	$146

COMPANY "NO GROWTH"					
Growth YoY	0%	0%	0%	0%	0%
Month	1	2	3	4	5
Revenue	$100	$100	$100	$100	$100

COMPANY "SHRINKING"					
Growth YoY	-10%	-10%	-10%	-10%	-10%
Month	1	2	3	4	5
Revenue	$100	$90	$81	$73	$66

In the case of the 10% year over year growth company, it is growing less than 1% per month. Yet the impact of this versus the no growth company is big. It's revenue is nearly 50% higher after year five.

The difference against the shrinking company is even larger. After five years, the growing company is nearly three times the revenue. Given many of the appealing aspects of software come from increased profitability as revenue scales, this difference in valuation is stark.

This also explains why Venture Capitalists (VCs) will pay very large multiples but only if the company is growing quickly. It also explains why VCs will stop putting money into a company and possibly leave it to die if the growth rate slows.

In the end, the buyer's expectation for future growth or lack thereof greatly impacts the valuation of a company. If a company is shrinking, even slowly, it decreases the value a purchaser can pay for a company and still turn a profit.

Most investment bankers and small business brokers know this math. It's why you always see revenue projections that have been flat for the past few years miraculously start to grow immediately after acquisition. Unfortunately, this is mostly delusional selling technique that buyers have learned to mostly ignore.

The best way to show a buyer that a software company will continue growing is to demonstrate growth over a long period of time.

GNAP ("Generally Not Acceptable Accounting Principles")

Like technical debt described earlier in this document, there is "operational debt" in many small software businesses. Where technical debt is associated with corners cut in order to get the product out the door or to utilize the team at-hand, the GNAP are the opposite of the GAAP ("Generally Accepted Accounting Principles") used by accountants. GNAP always shows up in the bookkeeping and accounting of the organization.

Does the company have solid financial statements? Is all revenue accounted for appropriately? Is each expense logged as it should be? Did the owner treat the company as their personal "piggy bank" to pay things like salaries to their kids or acquire personal vehicles? Each of these things clouds the ability for a purchaser to really understand how the business will perform post-acquisition.

At a deeper level, many small software companies are very sloppy with revenue recognition. It's easy to dig into a business and discover that 10% or more of the owner's perception of their revenue isn't actually recognizable under accounting rules. Just because the cash is in the bank or supposed to come into the bank, accountants treat it differently.

In the best case, the owner has treated the company like a real business. They have created annual financial statements using generally accepted accounting principles (GAAP) or some other common equivalent. The books have bee audited (or reviewed) by a licensed accounting firm. The business expenses have been true business expenses. The owner has paid themselves a market salary and bonus rather than cut a special deal.

Any deviation from that hygiene in the financial operation and the business valuation is going to take a hit. For a seller, do things the "right way" from the start or as soon as possible to maximize value.

B2B, B2C and Variations of B2B

Software sold to consumers (B2C) is very different in valuation than that sold to other businesses (B2B). Consumers are more fickle, harder to reach, harder to support, and often disappear quickly. Business customers are often more appealing, especially when they depend on software to run their business. If they can't leave your software without spending a ton of money to change, the software business is in a good position to assume they'll keep that customer.

B2B customers come in different shapes and sizes. At the high-end, "enterprise" customers are desirable because they stay with solutions for years and sometimes decades. As a buyer of a software business with enterprise

customers, you know that the business has a long future ahead of it. At the other end of the spectrum, some business customers act more like consumers. Examples here are small-time realtors or restaurants. A savvy buyer will realize that the future revenues for the business are less assured compared to a portfolio of enterprise customers.

The impact from the type of customers is due to the amount of assurance they provide to a buyer that the business will stay earning in the future. The more risky the customer base, the lower the value a buyer will assign to the company. If a seller has the opportunity to migrate the business towards more valuable customers, it is worth considering.

Sales Model

Most software businesses segment into one of three sales models:

1. **Direct:** Meaning sales representatives on your team are needed to sell the product
2. **Indirect:** A channel partner like a value added reseller handles selling the product to the end-customer
3. **Self-service:** Customers come to your website and sign up without talking to a salesperson.

Self-service typically commands the highest value to an acquirer due to an increased level of downside protection. To illustrate, let's say your self-service SaaS company encounters a challenging business environment. One path forward could be to maximize cash flow by stripping all investment in the product as well as cutting all sales and marketing. Since a self-service model has no sales people, this type of software business can run at very high profit margins in certain environments.

Direct and indirect sales models are tougher. If a purchaser removes the sales team entirely, their business will begin shrinking by the amount of churn. Most acquirers therefore model in that they must keep a sales and marketing team

around to grab the low-hanging fruit from potential customers. This means a hit on the cash the business can generate since those expenses cannot be removed.

Of all the factors, this is perhaps one of the most difficult to change. Many markets are impossible to address without a direct sales force. However, you can make the direct sales or channel sales models operate more efficiently to improve value at the time of exit.

Customer Churn

A company with 10% annual churn is worth much more than a company with 30% which is worth more than a company with 50% annual churn. This makes sense. The more customers leave the business each month, the more investment has to be made to acquire new revenue. Otherwise, the business will shrink.

If a business has low churn, the amount of additional sales necessary to keep the business growing is relatively small. If a business has high churn, like 3% a month, an owner must replace over 30%of their customer revenue each year just to keep revenue flat.

Of course, this affects valuation. If the business is naturally low churn or even experiences what is called net-negative-churn (established accounts are growing faster than the company loses revenue from churn), the business will price at the high-end of the ranges.

The secret to minimizing churn is a multi-pronged approach. Owners can make customer experience a top priority and implement programs to regularly monitor customer satisfaction and ensure you have the necessary support structure to deliver great customer outcomes. Sellers can also invest in "quality of life" improvements to the product to do a better job delighting customers as well. The first step, however, for many companies is actually tracking churn on a regular and consistent basis to understand the scope of the problem. You'd be surprised how many software companies have no idea as to the health of their customer base. In those situations, a buyer will have to assume the worst and that hurts exit value.

Total Addressable Market ("TAM") Ceiling / Shrinking TAM

Many software companies are subject to a disappearing Total Addressable Market (TAM). Let's take the idea of software for broadcast television. The market for this is clearly shrinking after it peaked in the late 1990s. A buyer of a software product where the market is getting smaller each year and will eventually go away must then consider that the revenue from the product will eventually go away also. This means that a purchaser will necessarily need to pay less in order to make the acquisition of a product sensible. This hurts the market value of a business with this characteristic.

Many times a seller will have no choice in terms of their market. In our broadcast television software company example above, it's not trivial for them to magically shift to be a cable television software company, for example. Sellers can, however, be mindful of their TAM challenges and make little decisions to stay relevant in their markets as long as possible.

Clear Go-To-Market

Many small software companies are for sale because they have failed to grow quickly or grow at all. Often this is because it is not clear how to actually find customers profitably. For example, if a software product is used for a niche application but there is no clear pattern in the buyer persona or customer demographics. Or the initial customers all came from personal relationships with the founders.

Another example is if the once-profitable customer acquisition channel has become flooded and is no longer profitable. Ad marketplaces like Google Adwords and Facebook are large and very profitable because they are efficient markets for advertisers and site owners. It is not uncommon for customer acquisition costs to triple in a few years as competitors bid up ad placements.

In these cases, a buyer will undoubtedly have the same problems acquiring new revenue as the seller because finding potential customers is challenging.

If the seller, who is an expert in the business, was unable to grow, what is the likelihood of a buyer with less market experience doing any better?

So, a business without a clear path to growth or at least new customers greater than the amount that naturally churn each month, will be of reduced value to a buyer.

The solution here for a seller is to spend time as a founder or with experts to solve for customer awareness and acquisition. If a seller can present a proven recipe to grow the business generated by quantified experiments, it usually increases the value at time of sale.

Technology Inflection Points

Software should accommodate the needs and user-preferences of the customers it serves. Cloud-native, browser-based, SaaS applications are the present and future. If your product is client/server (even if it's front end is in a web browser) or uses antiquated or niche web development stacks, you have implicitly locked yourself into the past and there is an accompanying drop in value.

Sellers often view high customer satisfaction as a prediction of product longevity. In practice, however, even the most loyal customers are subject to changes in work behavior if there is a more accessible, integrated alternative. It's also important to note that at an enterprise-level, where client/server still reigns supreme, software users aren't the only stakeholders. IT directors who once had to manage and update complex server schemes are beginning to favor cloud architecture. If your competitors are transitioning to, or already have, a cloud-native SaaS product you are at a serious disadvantage.

Making the transition to SaaS brings a host of risks with it. First, there is the team building the new product. Often times, the team equipped to build and maintain a client/server product does not have the skillset for developing web applications with cloud infrastructure. You either have to hire new team members, retrain the existing team, or outsource. Simultaneously, competitors

already offering a SaaS application are gaining market share and putting pressure on your loyal installed base. Then, on top of that, there is a pricing model shift and de-emphasis of the legacy product that jeopardizes your existing customer relationships.

Product transformation is possible and often necessary, but if you're selling before you've made that leap, you are handing off a tremendous amount of risk and expense to the new owners. Sellers can invest in keeping up with the latest technology as they operate the business to maximize value at exit.

Employee Engagement and Culture

If the buyer is planning to keep existing team members in a transaction, their engagement and culture is just as important as their skills.

Astute buyers of software companies know that engaged teams will radically outperform those who are burnt out and ready to leave at the earliest opportunity. How engaged is the team of the software business? The better they are, the less work the buyer will need to do to fix the situation. This affects the price towards the higher or lower end of the range.

Employee factors tie into the business model for the company as well. If, for example, a business is self-service in terms of selling and marketing to customers, then the impact of a negative team is minimal. If the business, on the other hand, requires direct selling and servicing of customers, then a disengaged team will be very expensive to an acquirer.

In many cases, companies that have decided to sell have gone through hard times. This often impacts the morale of teams and many at the time of selling are at a breaking point. If a seller is forced to replace elements of a team to keep the business on track, this is hit to profitability. It will therefore affect the overall acquisition price.

Many times small software companies have small teams that are loyal to their leaders. That often results in teams being paid salaries and compensation

below market. A team paid below market is a risk for a buyer. If the team isn't paid at replacement cost, the buyer is at risk of losing employees and of adding additional expense in the event of any team changes or replacements.

Leadership teams often underpay themselves. If the leadership team is moving on post-acquisition, their replacements will come at a higher cost, subtracting from the bottom line. It also presents risk for the buyer as what good leadership will cost is a serious unknown. The best practice is to pay the leadership and team a market salary that satisfies everyone.

Sellers can invest time and effort in company culture and the work environment. This includes the basics of good management like regular employee manager 1-1s, managerial attitude and inclusion of team members in decision-making. Even better is quantifying the level of employee engagement through many of the tools out there. Our favorite at Dura is the Q12 survey from Gallup to measure employee satisfaction. The higher you score on these, the higher value a buyer will attach to your business.

Exposure to Economic Cycles

If the software went away, would the customers' business still be able to function? If the answer is no, the buyer can be very certain the business will survive an economic downturn. All long-term buyers Given the current frothiness in the economy and the time since the Great Recession, many buyers expect a downturn will happen someday. So they will ask what will happen to a software business during a recession whenever that might be.

Exposure to systematic economic risk is a key aspect of business valuation for any buyer. A business can be growing like crazy today with 1% annual churn, but if a recession hits, and the product is not mission critical to the customer weathering the downturn, that history won't matter. An entire market can disappear overnight.

There are examples of "nice to have" software on the market today that are in tough positions should an economic downturn occur. Many are found in business needs that only occur during boom times. One example of that

category is around hiring software. In a recession, companies shed employees rather than gain them so hiring software is the first to get cut from budgets. Other industries especially hard-hit in a recession are transportation and shipping.

Buyers have to keep one eye on the most likely outcome and one eye on each of the best and worst scenarios. When there's a macroeconomic shift, for small, private companies, what could happen and what should happen can be very different things. A smart buyer prices in this volatility. The more indispensable the product is to the customer's entire organization, the lower the impact on price.

Sellers can work on adding features to become as essential to their customers as possible or expand beyond vulnerable industries to ones that do well in a downturn like healthcare or education. The good news is that the process of being more integral to your customers operation also ties hand in hand with improving user satisfaction. This is a unique category where improving one area of the business helps another!

Legal Hygiene

In previous sections, we spoke about company hygiene in things like accounting and technical debt. There is another bucket around legal hygiene. This is a term to describe the category of things that a business owner does to keep their contracts and agreements in order.

Does each employee have an employment agreement? Is the payroll being done legally with regards to legal filings with the state? Is there a technology/ invention assignment agreement with each employee? Are the contracts with vendors lock-tight to prevent disruption to the business? Is the same there for resellers and customers? And so on for each area of the business.

While expensive and sometimes painful, businesses that price at the high end of their range in the segmentation we described earlier have engaged lawyers throughout the formation and operation of their business. If not, the buyer will need to engage to do the work to clean up things before or after buying the business. That costs money and decreases the profit a buyer will be able to wring from the investment, meaning the price of the business will go down.

Before going to market, sellers should engage legal experts to get the legal hygiene for the business cleaned up. Buyers will ask for sellers to prepare it anyway so you're doing the work either now or later. This is a category where you can throw money at the problem to get it solved, which is nice.

"Bus Factor"

As an example, we examined a small Saas business run by a founder who is very prominent on social media. In talking to many of the customers, we discovered many only remained customers simply because they respected the founder. In that case, the business had non-transferable value.

Many small software businesses are actually highly dependent upon the founders personal relationships or reputation. If this is the case, when the business transfers, the risk posed for the buyer is high. Can you keep the customers after the founder leaves? What if the founder starts quietly expressing remorse about some aspect of their experience? All of this deducts from the market value of a small software company.

If possible, sellers should work to detach themselves from being essential to the operation or growth of the firm. Some of this is simple like separating your personal twitter account from the company one. It can also be accomplished by bringing other people to the forefront so customers get to know them as well. Lastly, promoting a company's brand rather than the founder's persona can help focus customers on the solution rather than the people.

Gross Margins

Many software companies are valued in terms of annual recurring revenue. But, not all recurring revenue is created equal. One of the biggest contributors to the overall value of a company's revenue is its gross margin. Gross margin is defined as the cost required to deliver a service or good. In the case of software businesses, this is typically made up by hosting costs and support costs. It's the bucket of expenses that scale linearly with revenue.

A key economic advantage of software businesses is their extremely high gross margins. Some software businesses like self-service Saas businesses can operate at 90-95% gross margins or better. Others may require more servers or staff to support their revenues which can reduce margins to 80% or lower.

A pure SaaS company showing gross margins below 80% can often indicate engineering deficiencies or inefficient hosting architecture. If possible, sellers can invest in the product to make things better for an acquirer. If a software product is cloud-based, then investing to optimize the code to reduce server expenditures can drop more profit straight to the bottom line. If a product is packaged software, sellers can automate and optimize delivery packaging or add features to reduce support costs in order to improve gross margins.

Other "software companies" with gross margins below 70% often have a large hardware or service revenue composition. At these levels, non-software revenue becomes substantial and acquirers will likely adjust multiples to non-software business levels.

Willingness of Ownership to Help

When a buyer acquires the company, the real work begins. No matter how much work is done during due diligence, there will always be surprises that come up after closing.

Some sellers are willing to stay involved either as paid consultants, temporary employees or as permanent leaders of the acquired business. Obviously, the most valuable to a seller is to acquire a company with intact high-performing leadership. If a seller needs to put their own leadership into the company and risk that it'll do as well as the seller running the business, that increases the challenge associated with the acquisition. That would negatively affect the valuation of the company.

This can get even worse as some sellers want nothing to do with their old business post-acquisition. As a buyer, it's a big challenge when you are unable to even call the previous management to ask about a newly discovered issue.

Figuring out things from scratch is difficult without the "phone a friend" option described here.

The more the management is willing to stay involved in making the company a success, the higher it'll trade in the multiple range. If a founder, on the other hand, is of the mind that they want to need to get out right away and not answer phone calls or help post-close, this hurts the sales price.

Given this is mostly a mental thing, sellers should manage their time and attitude through taking some time off or finding another path to recharge their batteries. Sellers who can honestly say, "I'm here to help you and my team succeed after I exit" will generate higher multiples at exit over the founder whose mind is already on the beach!

Cosmetic Niche

Successful software companies often start by carving out a niche. For most, this means identifying features in your product that serve the needs of a target vertical or end-user better competitors. Companies can do this either intentionally by developing functionality specifically for a given industry or discover it overtime based on the makeup of their customer base. The former is more attractive to a buyer because the competitive advantage comes from expertise and intentionally building to the user, which yields stronger customer relationships.

Unless the product feature leading to competitive advantage is hard to replicate and rooted in hard-to-come-by industry expertise, the niche only lasts until someone starts spending more money. The deeper the moat, the more favorable the valuation at the time of exit.

Financing Hygiene

Cashflow is the most important indicator of a business's health. It is also very difficult to manage, even in recurring revenue businesses. Sometimes, in order to manage cash month to month, startups have to get creative to fill gaps or make investments. Requiring short term financing to cover working capital needs is an indication of a struggling business.

A common example of this is invoice factoring. Factoring is both an indication and creator of financial risk. It says to a buyer:

1. There are cash flow problems
2. We don't own our account receivables or, at the very least, we have an high-priced loan collateralized with our AR

Most importantly factoring puts customer relationships at risk. Everything that worries a buyer about factoring, worries a customer even more. The moment they find out, customers will become nervous and begin looking for alternatives. Anything that increases churn risk, decreases business value.

The answer here is for sellers to work closely with their financing sources to keep it clean and above-board. Ideally, the highest-valued companies at exit are funded solely through customer revenue with little to no debt and no outsiders to influence the ability to make a sale happen. Slightly less appealing are commonplace funding sources like bank debt, Saas lenders, or venture capital. Avoiding the trap of factoring, credit card, or other high-interest from the beginning is ideal, of course.

Threat of New Entrants

Copying is the sincerest form of flattery. Whether you were the first to market with your product or you have a unique feature that no other player has, odds are good someone will attempt to do what you're doing if there is a big enough market for it.

No matter how strong a product is, if there are big, well-funded competitors in your space or an adjacent market or an open source alternative, buyers have to consider the risk of commoditization. The best museum artifact warehouse ERP in the world at a $3mm run rate does not stand a chance against SAP in the long run if they decide to enter that corner of the market. Buyers analyze the likelihoods of these risks and adjust value one way or the other.

Similarly, many businesses are built on features that will ultimately become something a larger platform provider includes for free. The classic example was Microsoft offering their web browser and web server into the Windows

operating system. This undercut the ability for the startup Netscape to compete. Today, you can see the same thing happening with Amazon and many of the tools that are being built for sellers on their platform.

A solution here for a seller is a multi-year process, unfortunately. It involves identifying the trends happening in your industry and then adopting changes to keep your business from eroding. This can be done by adding features or services that new entrants cannot replicate. Otherwise, buyers will not highly value businesses for sale that essentially are "picking up nickels in front of a steamroller."

Needing Investment to Unlock Growth

Many factors contribute to a startups ability to grow- high churn, product-market fit, market opportunity, sales strategy, marketing, capital constraints, etc. The most common cited impediment to growth is capital constraints. If I had more sales people or money to spend on marketing, my business would grow exponentially every year, right?

The reality is no matter how much money gets spent, the majority of startups grow linearly. There's a reason most VC-funded companies fail. Growth cannot be boiled down to dollars spent. It is a complex puzzle to unlock – and a far harder and riskier one for businesses sub-$10mm. A $100k salesperson is a much bigger gamble, and has a much greater impact on the earnings of a $2mm company than a $12mm.

Often sellers will ask for a sale price that discounts the current reality of the business in favor of future potential. The expectation is that a buyer will pay a high price for the opportunity to unlock the potential of the business by spending even more capital. A financial buyer will have a hard time agreeing to pay a seller for the value the buyer is adding.

Given every seller is optimistic about the prospects for future growth, many buyers discount these projections. If a seller wants to extract value for a growth story, the best way to do that is go about proving growth can indeed happen.

Even for a short period of say a few months, that is enough to prove to a buyer that perhaps the trend can continue under their leadership. This is a means to get a higher valuation at exit.

Consistency and Predictability

Consider two businesses. Business X grows 10% in year 1, 70% in year 2, then 10% in year 3. 2.05. Business Y grows 25% each year for three years. In those three years, both businesses were just about doubled in size.

The perhaps surprising detail is that most buyers would prefer business Y. The idea is that predictability is preferred over variability. The hope as a seller is to keep the business growing in a nice and steady, predictable manner to maximize a value at exit instead of wild gyrations in profit and revenue.

On the other end of this spectrum, some small software companies present almost unbelievable narratives about their business. For example, a $2mm ARR software company that has run at 50% EBITDA for two years tells a strong story to a buyer. That story is not what the seller thinks, however. Buyers know that most small companies with that large of a profit indicates some level of corner-cutting. They know that those "chickens will always come home to roost" and the buyer will be expected to invest in addressing the areas in which the business has been missing reinvestment. If a business has been running too lean such that the "candle has been burning at both ends", sellers should expect a discount on the multiple that sellers can expect at M&A sales time.

A final note on break-even software companies. Breaking even is a milestone in the life of a startup, but the context is extremely important. Two months of break even and years of cashburn is heading in a positive direction, but is yet to prove a trend. Time proves consistency and that is valuable to buyers.

Sellers are usually entrepreneurs. Entrepreneurs are famous for being overly optimistic almost to the point of delusion. Wise buyers will not take your word for it on consistency and predictability of the business going forward. Best to do the hard work in the years leading up to a sale to prove it to them.

Highly-Valued Competitors

Often sellers will point to the valuations of their competitors as a point of comparison. Frequently these competitors are larger, venture-backed products. While it's true that M&A activity can validate market viability, if a competitor was purchased for a high multiple, all that means for certain is that you have a larger, better-capitalized competitor.

For sellers, it's often best to not focus on competitors in the sales process. Instead, focus on how your product and company can better delight the market that it already targets. Come to the sales process with data on your customers to demonstrate that your highly funded and highly valued competitors offer no threat.

Conclusion: Not All Small Software Companies Are Created Equal

While valuation of small businesses remains an inexact science, it's hoped that this guide will help sellers of small software companies understand the full extent of the world of small software company M&A and how to maximize the value at the time of exit. The good news is that most of these fixes to a company are just good business practices. Those will pay off even if a company ends up not selling.

And a brief commercial for our company, Dura Software. We think it's important to evaluate what type of home you want to find for your business. In many cases, sellers have spent years building their company using time they didn't spend with loved ones. We've built the type of acquirer that we'd want to sell to that takes care of your legacy, customers, and employees through our permanent ownership model.

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