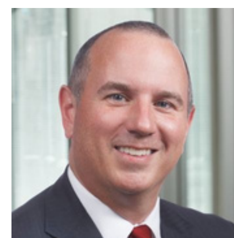
Software Company Valuations in a Volatile Interest Rate Environment

Cut through the noise and understand how markets think about valuation

By Matt Kentner

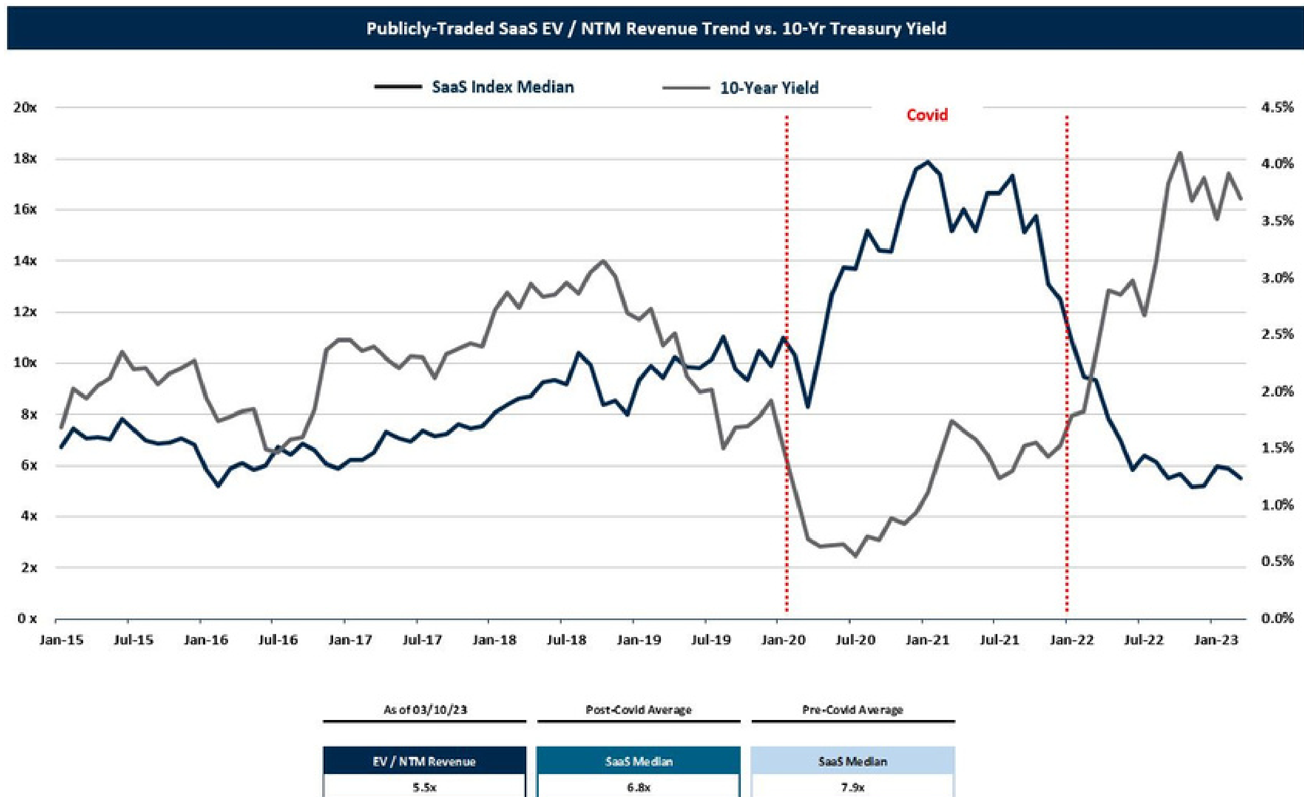


Matt Kentner
Managing Director,
Software and Business Services
(501) 251-4953
matt.kentner@stephens.com

One of the most important enterprise valuation drivers—specifically for Software as a Service (SaaS) businesses—is revenue growth. During the pandemic, SaaS company revenue multiples were at an all-time high in both the public and private capital markets. In a historically low interest rate environment, "growth-at-all-costs" became an unfortunately familiar phrase.

Why does a path to profitability matter to investors—arguably now more than ever? As markets seek a post-pandemic "new normal," and debate future interest rate trends, scrutiny of a company's profitability path has intensified. As early as mid-2022, we noted renewed investor focus on the "Rule of 40." Rule of 40-type indicators look to a company's top-line growth rate percentage plus a free cash flow margin percentage and typically attribute premium values when that sum is greater than 40 percent. For growth-oriented software companies, and especially considering recent shockwaves caused by the latest banking crisis, the importance of demonstrating profitable growth in a SaaS or SaaS-like business model can't be overstated.

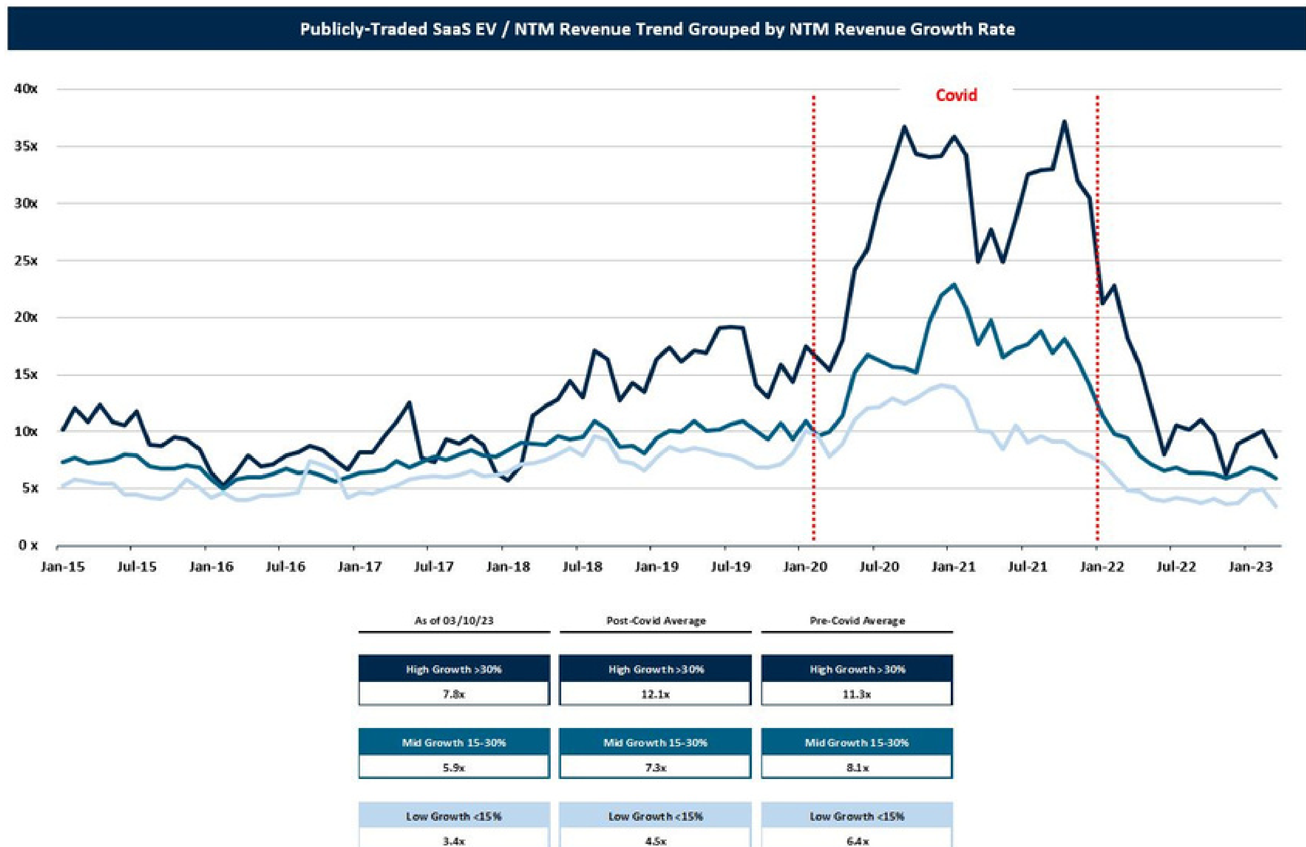
With the benefit of hindsight, we can look back on a multi-year global pandemic and layer a number of data points, pre- and post-pandemic. Publicly-traded SaaS valuation performance and a clear pandemic-era valuation bubble are generally not as noteworthy as the inverse relationship of valuation trends and interest rates. This is especially interesting in light of the current macro-environment outlook.



As of 03/10/23	Post-Covid Average	Pre-Covid Average
EV / NTM Revenue	SaaS Median	SaaS Median
5.5x	6.8x	7.9x

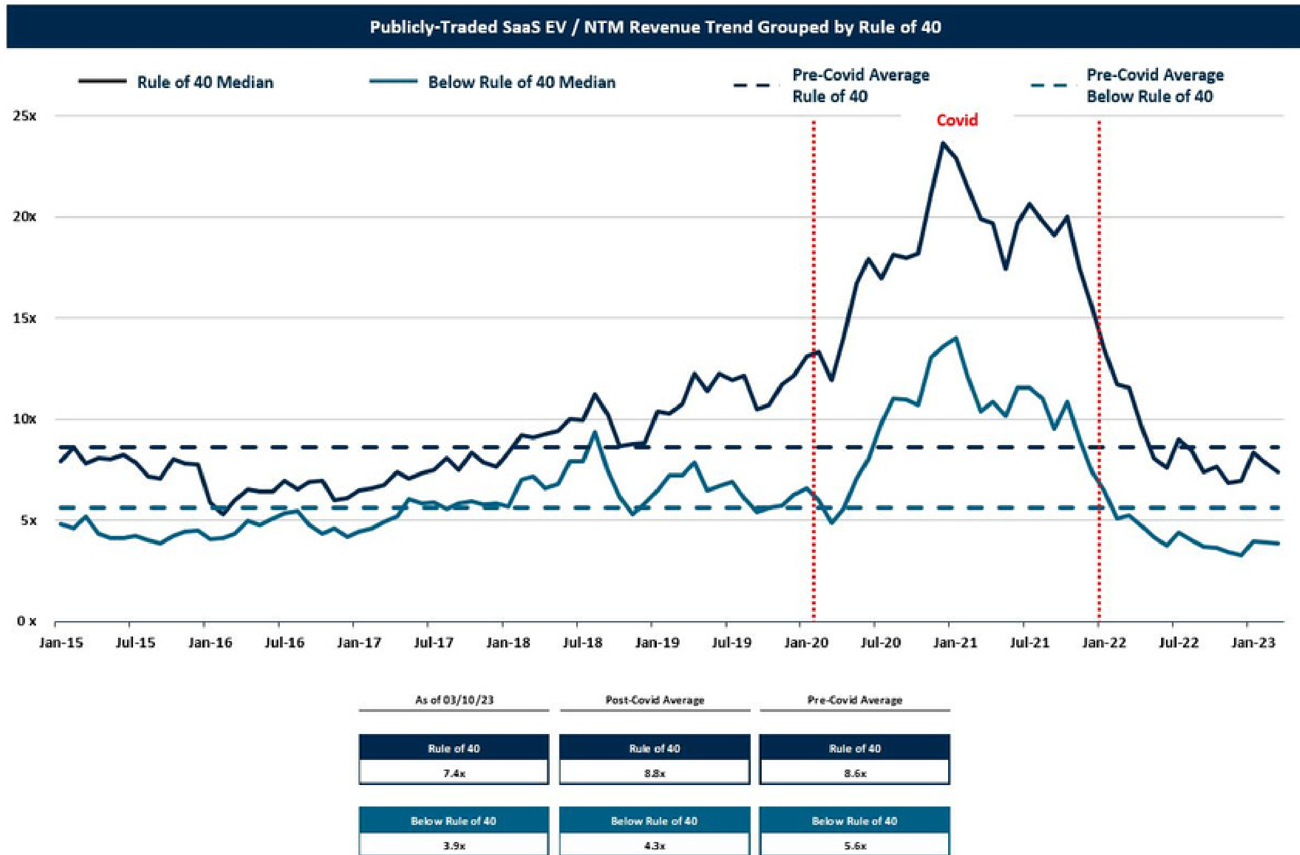
These trends are consistent among both public and private markets and highlighted by what we see among transaction precedent valuation data. Overall, average revenue multiples for SaaS transactions in the last 12 months are down about two turns from 9-10x in 2021 and early 2022, to 7-8x of late. For those of us actively advising companies, boards, investors, and founders, we know these post-COVID data points are the topic of conversation every day. Overall, SaaS/Software valuations are trading down to five-year low territory. Does this mean a stakeholder's vision of a premium revenue multiple is a thing of the past? No.

What it does mean is that an understanding of the current market and rigorous financial analysis is critical as decision-makers wrestle with "Do I sell or do I wait? And what valuation can I expect from this market?"



As noted above, growth is still key. High growth public comps are generally the highest valued businesses. Relatively lower growth software names are valued even lower than the pre-pandemic era. But once again, what is the market telling us about profitability?

The market continues to place a premium on growth, but not growth-at-all-costs. Our analysis demonstrates a now-more-than 4x difference in the Rule of 40 profiles versus Below-Rule of 40 profiles. Premium values still exist. Investors are also discerning, more than in recent memory, regarding a company's profitability margins.



Two additional items, qualitatively embedded in the data and our market experience:

1 businesses burning significant cash are increasingly a binary decision (i.e., go/no-go) for investors; and

2 if the economy slows and forward metrics decrease, multiples could ultimately return to previous years' levels.

Further, recent negative headlines around banking and lending and resulting impacts on venture and software investing all stand to further exacerbate the issues highlighted by this article.

Why Stephens’ Advice Sets Us Apart

Our banking clients and prospects look to Stephens as they evaluate market valuations and potential strategies prior to launching interactions with counterparties. At Stephens, we are focused on helping our relationships proactively prepare for these and other issues.

Preparation through rigorous financial analysis is not limited to top-line growth and profit margin. Software companies’ qualitative and quantitative valuation drivers include customer retention and churn, customer lifetime value versus customer acquisition cost, total addressable market and penetration, customer diversification, and a host of other financial and business considerations. In this environment, understanding the financial impact of key deal terms and securities is vital. Thinking beyond just “valuation” is more critical than ever.

Our investment banking team works with a company’s accountants, legal advisors, and management team to orchestrate important milestones in a company’s history. Our clients benefit from our long-term experience working on buy-side and sell-side transactions with all types of counterparties. Beware of advisors or potential investors looking to bait and switch decision-makers with careless references to outdated valuation trends and then only to blame “the market” when these promises fall short.

Source: Capital IQ and FactSet as of 3/10/23.

This material has been prepared solely for informative purposes as of its stated date and is not a solicitation, or an offer, to buy or sell any security. It does not purport to be a complete description of the securities, markets or developments referred to in the material. Information included in the material was obtained from sources which we consider reliable, but we have not independently verified such information and do not guarantee that it is accurate or complete. No subsequent publication or distribution of this material shall mean or imply that any such information or opinion remains current at any time after the stated date of the material. We do not undertake to advise you of any changes in any such information or opinion. Additional information is available upon request.

“Stephens” (the company brand name) is a leading family-owned independent financial services firm. Stephens’ US operations are headquartered in Little Rock, AR, with strategic locations in the US and a European presence in the UK and Germany. Stephens Inc. is a Member of the New York Stock Exchange and the Securities Investor Protection Corporation and is regulated by the United States Securities and Exchange Commission and the Financial Industry Regulatory Authority. Stephens Europe Limited (Registered office: 12 Arthur Street, London, EC4R 9AB, Registered number 8817024) is authorised and regulated by the Financial Conduct Authority. For more information, visit www.stephens.com. © 2023 Stephens