

THINKstrategies



# *A Whitepaper for Software-as-a-Service Vendors*

## **Understanding the Financial Implications of the Software-as-a- Service Business Model**

An Independent analysis published in conjunction with SaaS Capital, Inc.



**SaaS CAPITAL**  
INC

## Executive Overview

The Software-as-a-Service (SaaS) market is growing rapidly in response to a variety of macro-market trends. These drivers are encouraging organizations of all sizes to consider and adopt a widening array of SaaS alternatives to traditional on-premise software applications.

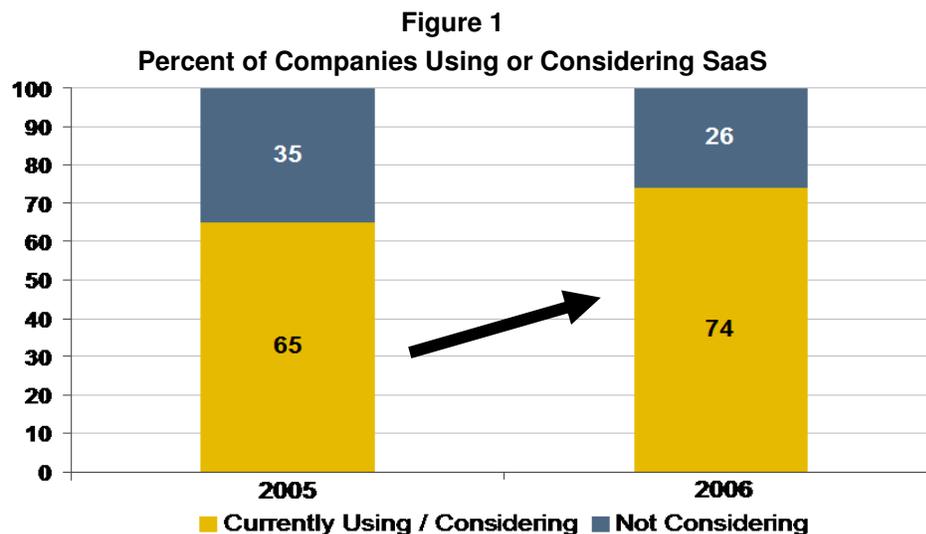
Although the rapid growth of SaaS offers an exciting time for entrepreneurs and established software vendors, the SaaS model also poses significant business challenges – not the least of which is cash-flow. While many entrepreneurs will seek venture capital to finance their start-up companies, the unique business requirements of the SaaS market is making it increasingly apparent that alternative financing should also be part of the financing mix.

Instead of being able to finance their operations from their customers through the upfront value of a perpetual license, SaaS vendors must find alternative methods to support their growth capital needs. The financial strain created by the SaaS subscription model is compounded by the relatively high costs of sales and marketing in the SaaS market.

This whitepaper will examine how the pay-as-you-go, subscription model is driving aspiring SaaS players to pursue funding alternatives to support their business operations. The good news for SaaS vendors is that the very financial elements that make SaaS companies require more capital, are the qualities that make them good borrowers. We will specifically look at how SaaS Capital, Inc. is responding to this need and helping SaaS vendors achieve their business objectives with debt financing options.

## The Movement to On-Demand and SaaS Solutions

THINKstrategies, in conjunction with Cutter Consortium, has surveyed IT and business decision-makers worldwide and found the proportion of organizations that have adopted or are considering SaaS solutions has jumped from 65% in 2005 to 74% in 2006 (Figure 1).



*Source: THINKstrategies/Cutter Consortium 2005 and 2006.*

THINKstrategies and Cutter Consortium’s surveys also found that over 80% of SaaS users are satisfied with their on-demand solutions, plan to expand their use of SaaS, and would encourage their peers to consider SaaS solutions.

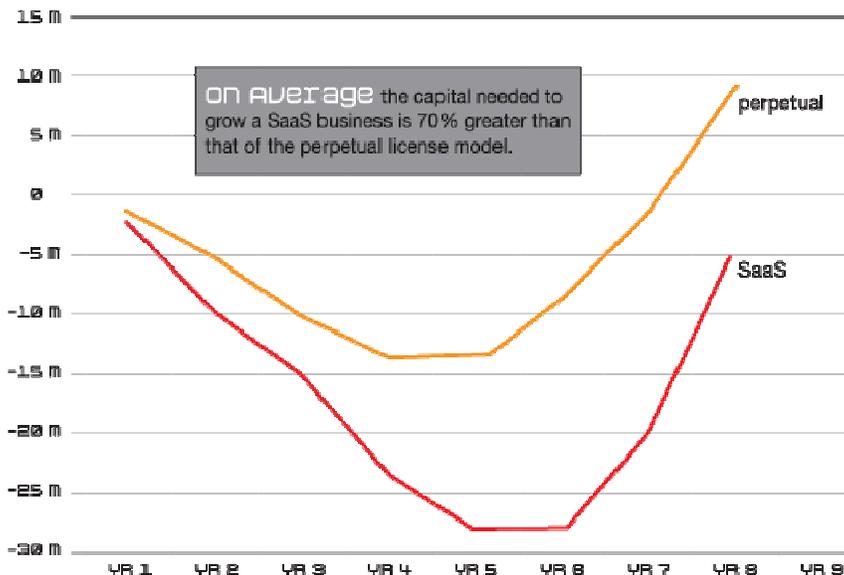
The success of these SaaS deployments has led Gartner to predict that 25% of software sales will be via an on-demand model by 2010. IDC forecasts the SaaS market will grow at a 21% compound annual growth rate (CAGR) over the next two years and reach \$10.7B worldwide in 2009.

## Financial Challenges of the SaaS Model

One of the largest challenges of the SaaS model is obviously payment terms. Getting paid monthly or quarterly versus getting paid one very large check up front is the major driver of the need for more cash to fund operations. Even getting the first year’s payments all in advance is still significantly less cash than the perpetual model. Figure 2 shows, assuming the same selling cost, the dramatic difference in cumulative cash burn based on when the software company gets paid. This leads to a cash flow squeeze, as cash coming in significantly trails bookings. Bottom line, a SaaS company can take 50-70% more capital to grow than a perpetual license model company.

Figure 2

The Costs of Capital for SaaS vs. Perpetual License Software Companies  
Cumulative Cash Burn



### Where Does The Money Go? - Sales and Marketing Costs

While many of the enabling technologies and services for SaaS are relatively inexpensive compared with the large investments required to build and support legacy applications, the costs of acquiring and supporting SaaS customers is significant - particularly as a percent of revenues. A review of SaaS company IPO filings shows that large amounts of investment in operations (sales, marketing,

hosting and professional services) were required to launch SaaS companies - sometimes at a rate of 2x revenues.

For example, NetSuite, Inc.'s recent Securities and Exchange Commission (SEC) filing for its Initial Public Offering (IPO) clearly shows the large sales and marketing costs for acquiring SaaS customers. The filing showed that NetSuite generated \$17.7 million in revenue in 2004, \$36.4 million in 2005, and \$67.2 million in 2006. However, its sales and marketing costs surpassed revenues in 2004 and 2005, equaling \$27 million in 2004 and \$39.2 million in 2005. It wasn't until 2006 when NetSuite was able to spend 'just' 53% of revenue on sales and marketing. SuccessFactors has also submitted SEC papers for an IPO that show the company spent \$32.3 million — 99% of revenues — on sales and marketing.

Of note, however, the high selling cost as a percent of revenue does not mean the total costs are actually higher. Instead, to a large degree, it reflects how the revenues are recorded in the SaaS model. For instance, if a traditional ISV has three sales people each costing \$100,000 a year in salaries and commissions, and they generate \$1.5 million in perpetual licenses in Q4, the selling cost as a percent of revenue is 20% for that year. However, if a SaaS vendor has the same three sales people sell \$1.5 million in three-year contracts in Q4 the selling cost would be 240% because only a small portion of the revenue is recognized. On a cash basis, many of the expenses are paid out before the cash is received from the customer.

### It All Adds up to More Money

While the annuity stream of SaaS companies has become increasingly attractive to the investment community, Will Price of Hummer Winblad Venture Partners estimates that it takes 1.6x longer for SaaS companies to become liquid compared to traditional software companies and requires 1.75x more revenue and 3.65x more capital to achieve profitability. Our research confirms his assertions and the listing of recent SaaS IPO's in Table 1 reflects the capital intensity of the model.

**Table 1**  
**Pre-IPO Equity Investments in SaaS Companies 2004-2006**

<u>Company</u>	<u>Pre-IPO Equity (\$000)</u>	<u>IPO Year</u>
RightNow	\$31,740	2004
Salesforce.com	\$88,570	2004
Black Board	\$130,032	2004
Kenexa	\$71,408	2005
Dealer Track	\$79,907	2005
Omniture	\$54,508	2006

Of the last 6 IPO's of SaaS companies, the average amount of venture capital raised was \$76 million prior to IPO. This amount of capital is not only dilutive to the founders and common shareholders, it's also dilutive to the VC's who are striving to be equity efficient.

## Current Financing Options

Since SaaS companies can take 50% to 300% more cash to build than traditional perpetual license software companies, financing all the additional cash needs with equity sources is not an efficient use of capital for the company founders, management team or the VC investors. It's an expensive way to do it both for the VC's and all the other shareholders, including dilution to management, as the model tends to lead to Series C, D, E, and then AA, etc.

On the flip side, technology focused banks are constrained by the lack of traditional sources of repayment, namely profits and/or assets, both of which are in short supply for an emerging SaaS business. Unprofitable businesses with little in the way of assets are a mismatch for banks. As a result, few of these institutions are willing to commit meaningful funds to SaaS companies to meet their working capital needs. The structures they do provide can help, but are typically confined to 60 day accounts receivable loans, or loans to purchase servers or other hardware.

The emerging products of venture debt companies are an option for SaaS companies. These lenders are more aggressive in their approach and are not constrained by regulatory issues. The big drawback with venture debt, however, is the structure. They are most aggressive about lending to SaaS companies when they have just raised an equity round. That is precisely when the company does not need the cash. Borrowers end up spending a lot of money paying interest on debt they don't yet need. By the time they do need the cash, the loan has been amortized down and they are left with debt service, not liquidity. Venture debt can be even more expensive when the value of the warrants is considered.

## An Emerging Alternative

Unlike perpetual license counterparts who typically have highly variable revenue streams, SaaS companies are actually good candidates for debt. The stable cash flows, high margins and discretionary expenses of SaaS provide a strong foundation for lending for those who understand the model.

By understanding the lack of profitability and assets, a new approach pioneered by SaaS Capital focuses on the key strength and inherent value of the SaaS model in order to let SaaS companies monetize a portion of their unbilled future cash flows. Set up much like a line of credit, the SaaS Capital's debt facilities are designed to provide growth capital when needed and also to grow with the business. So, as a SaaS company's bookings grow, so does the size of the credit line. Typically, facilities are structured as a multiple of recurring monthly revenue or a percent of unbilled long term contract value.

Because of its pure SaaS focus, SaaS Capital is able to assess the debt service capability of SaaS companies quickly and lend them enough capital to meet their operational needs. It's very important not to over-leverage a SaaS business too early in their growth cycle. Debt is not a substitute for early stage equity funding, and customers should reach more than \$3 million in recurring revenue before they leverage their business in a meaningful way.

## Summary and Conclusions

The rapid growth of the SaaS market has attracted a proliferation of aspiring SaaS vendors, and in turn, those interested in capitalizing on the new market opportunity. And while this new market is an exciting opportunity for entrepreneurs and established software vendors, the SaaS model also poses significant business challenges. In particular, the pay-as-you-go subscription fee structure which is at the heart of the SaaS value proposition creates dangerous cash-flow traps that can hinder company growth and threaten long-term survival.

Current financing options such as greater venture funding can solve this problem, but it's an expensive way to do it both for the VC's and all the other shareholders. Traditional lenders are constrained by the lack of traditional sources of repayment, namely profits or assets, both of which are in short supply for an emerging SaaS business. As a result, few of these institutions are willing to lend much in the way of funds to SaaS companies to meet their working capital needs.

SaaS Capital has created a new and unique approach to debt financing for SaaS companies. Via an inherent understanding of the SaaS model, SaaS Capital looks to the stable cash-flows, high gross margins, and discretionary expenses to provide meaningful levels of debt financing. When combined with their capacity to run the underlying SaaS applications they finance if they need to, SaaS Capital is uniquely well-suited to serve the SaaS market.

***This whitepaper was published in conjunction with SaaS Capital, Inc.***

### **About SaaS Capital, Inc.**

SaaS Capital launched its business to provide working-capital debt facilities to Software-as-a-Service (SaaS) companies. By leveraging the predictable revenue streams and future contract values of the SaaS model, SaaS Capital's credit facilities allow SaaS companies to accelerate future cash-flow streams to fund operations today. SaaS Capital's products are non-dilutive, provide more availability than traditional accounts receivable financing, and are structured with flexible terms to meet the needs of SaaS businesses. To learn more about SaaS Capital visit <http://www.saas-capital.com> or call 513-277-0898.

### **About THINKstrategies, Inc.**

*THINKstrategies is a strategic consulting services company formed specifically to address the unprecedented business challenges facing IT managers, solutions providers, and investors today as the technology industry shifts toward a services orientation. The company's mission is to help our clients re-THINK their corporate strategies, and refocus their limited resources to achieve their business objectives. THINKstrategies has also founded the **Software-as-a-Service Showplace** ([www.saas-showplace.com](http://www.saas-showplace.com)), an easy-to-use, online directory and resource center of over 1800 company listings from around the world organized into over 80 Application and Industry categories, and insights and information regarding industry best practices. For more information regarding our unique services, visit [www.thinkstrategies.com](http://www.thinkstrategies.com), or contact us at [info@thinkstrategies.com](mailto:info@thinkstrategies.com).*