Software Company Business Valuation

By Dave Kauppi, President MidMarket Capital

What business valuation would you place on a distribution management software company with $1.5 million in annual revenues and $500,000 in losses? How about a healthcare software ASP with $300 K in revenues that is breaking even? These companies don't exactly fit the 5 times EBITDA or the discounted cash flow valuation models.

That is what makes software or technology based companies so much fun to sell. Arriving at a business value is done the old fashion way. You identify the universe of likely buyers, prepare your blind profile and NDA, and contact the president or person in charge of mergers and acquisitions. What you are trying to accomplish is to identify and articulate the strategic rationale for considering this acquisition.

In the example above, our distribution management software company had adapted their software to a new vertical market while also introducing it on Microsoft's .NET platform and upgrading from green screen to GUI interfaces. They were not getting any traction in the new vertical competing against the two dominant players in that space. They had, however, created a lot of value in their technology. They were a very good acquisition candidate for one of the dominant competitors. They had "leap-frogged" this competitor with a more modern platform. The competitor, through a series of prior acquisitions, was actually supporting six different software platforms for essentially the same capability. They were contemplating a long and expensive system rewrite. They needed to consolidate platforms, but did not have an upgrade path for their installed clients. Their clients were vulnerable to defections.

We approached the president and positioned our client as follows:

1. Purchase our client for a favorable buy versus build outcome.

2. Time to market – We could provide an immediate upgrade path versus eighteen months of development

3. Substantial cost savings – By rationalizing their software platform and reducing the number of supported systems

4. Immediately end customer defections by announcing an actual upgrade path versus years of promises

5. Prevent a more formidable competitor from getting his hands on this technology and causing them some real damage

The good news is it worked and we were able to get our sellers north of $2.5 million. Over a year later it has proven to be a good deal for both buyer and seller.

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The healthcare ASP also turned out to be a strategic fit for a much larger healthcare IT firm. This established company had previously delivered their software through a traditional licensing approach where their clients managed their own internal systems. The buyers needed our client's cutting edge module that completed their suite of products. They intend to use the ASP model as the springboard to launch their entire product suite on the ASP model to complement their licensing approach.

Much of this transaction value was in the form of a well structured earn out. Both buyer and seller feel comfortable that the sales targets will be met and will provide the maximum contractual payment. This will result in a value for the seller of about $2.5 million. The buyer's customer base of 1400 hospitals are prime candidates to upgrade their current software system (the buyer's product of course) with this new capability. The seller achieves a 20 times improvement in the sale of their product as part of the large company. The large company increases revenues and uses a portion of that revenue to complete the purchase price obligation. It was accretive from day one.

When it comes to software or technology companies and business valuation, beauty is in the eye of the beholder. If the company can identify the right buyers and if they can be positioned as a strategic fit, traditional valuation metrics may not apply.

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