# Revenue Models and its Implications on Future Financing or Exits

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ALLIED ADVISERS

Investment Banking for Technology Companies and Investors

## Revenue Models and its Implications on Future Financing or Exits

In M&A or investment transactions, the "revenue model" of the target company is a key filter which will determine the ultimate interest level of the buyer or investor, and if so at what valuation, and hence is a critical determinant of success. Simply put, revenue model is a part of a company's business model that explains how the company generates income (revenue streams) by providing value to customers. The term "revenue stream" simply means a single source of revenue a business generates and is often used interchangeably with revenue model.

A business may operate with one or multiple revenue models depending on the nature of its offerings, customers or market segment served by it. The choice of revenue model(s) for a business is usually dictated by one or more of the following considerations:

- Revenue models typical to a business sector or industry
- Nature of product or services provided
- Repeatability and sustainability of revenue streams
- Profitability of revenue streams
- Go-to-Market (GTM) and channel strategies

## TYPES OF REVENUE MODELS

While there are a myriad types of revenue models, below are a few of the most common and popular ones and their characteristics.

### 1. SUBSCRIPTION/RECURRING MODELS

A business with this revenue model provides a product or service for which customers pay periodically over longer periods of time, usually month to month, or year to year, or multi-year. The common types of such revenue models are the following:

(i) **Subscriptions:** unlike software licensing where a user pays upfront, a user receives access to software by paying a monthly or annual subscription fee. The Software as a Service (SaaS) industry has exploded in the last 15-20 years, with leading companies such as Adobe, Atlassian, Salesforce and ServiceNow etc. growing to over $100B in market value. There are a variety of subscription models or which a select few are noted below. We will provide a more detailed view in a subsequent report.

   a. **Per User:** fee per each user of software, charged on a periodic basis (e.g. Salesforce, Workday). The pricing could be tiered based on number of users

b. **Usage Based:** fees based on level of consumption of the offering using different metrics. Examples include cable or mobile phone services like Comcast or AT&T where users are charged based on amount of data consumed, number of channels subscribed to or number of text messages

c. **Flat-Rate:** customers are charged a single fee regardless of number of users or amount of service consumed (one-size-fits-all). This subscription type is less common without a tiering model. For example, cable companies like Cox have tiered broadband models for home WiFi

d. **Feature Based:** software is charged based on level of functionality. Higher pricing tiers provide additional features and usability and the lowest pricing tier could be free, offering the most basic functionality of the software. Examples include website development software such as Wordpress and Wix, or content collaboration platforms like Citrix

(ii) **Managed Services:** a business provides valuable services on an ongoing basis to customers, who pay a pre-determined fee monthly or annually. Examples of such business activities include computer hardware/software maintenance, communication management and security management. Examples of managed services companies are CDW, Insight and Rackspace

(iii) **Memberships:** customers pay a business on a periodic basis for access to facilities, services or products. Common examples of such businesses include insurers, and digital media publishers like UnitedHealthcare, New York Times and LinkedIn

Subscription models are generally the most reliable revenue streams since the fees are recurring and attractive to the end user and the costs are spread over term of the usage thereby reducing upfront costs. Subscription models also provide the highest margins relative to other types of revenue streams because once the platform for providing the offering has been paid for, the incremental revenue from new customers has a low cost to service (primarily the cost of cloud hosting and other expenses like the cost of any third party software which is used in delivering product and any personnel cost directly tied to running and delivering the SaaS product to users), and layers on top of revenue streams from existing customers, creating strong scale economics. Top tier SaaS companies generate well in excess of 80% gross margins. See also our related report on Brief Analysis (SaaS): Rule of 40 which speaks more to how strong gross margins improve valuation.

## 2. TRANSACTIONAL MODELS

Transactional revenue models are very popular with businesses because it is one of the most direct and obvious ways of generating revenue as it entails a company offering units of product or service in return for payment per unit of such offering. Examples of transactional models include:

(i) **Internet/Web:** Customers pay directly for products marketed on websites (e.g. Amazon, Walmart.com)

(ii) **App Store:** Owned by firms such as Apple, Google where app developer pays 20-30% of their revenues

(iii) **Ad-Based:** Revenue is generated on a per-view or per-click basis from ads placed on websites (e.g. Facebook, Google)

(iv) **Commissions:** A business charges a fee per transaction or a percentage of the value of transaction. Examples include payment processing, stock trading, insurance/employment marketplaces, ride share, food delivery or accommodation services (e.g. PayPal, Monster.com, Uber, Airbnb, Stripe)

(v) **Licensing:** Software or hardware products sold for a per-unit licensing fee that is usually a one-time payment. Examples include Microsoft Windows and most video games

(vi) **Pay-per-Use:** This revenue model is commonly used by public cloud providers like Amazon Web Services (AWS), Microsoft Azure and Google Cloud Platform (GCP). Customers are charged based on computing power / memory / resources / time used

Transactional models have less predictable revenue streams compared to subscription models and require significant amount of transactions to get to meaningful revenue. The challenges to this model are usually competition, margins and scalability.

## 3. PROJECT-BASED MODELS

Most common in professional services industries such as IT Services, Consulting and Accounting, project-based revenue models price the time of workers involved in a project. Typically, projects are priced as:

(i) **Time & Materials:** Based on the time spent by workers on the project; this is typically charged on an hourly or daily or monthly basis, with a profit margin built in over the cost of the workers

(ii) **Fixed Price:** A fixed charge for a project that imputes the time and costs of the workers and a profit margin built in

Project-based business models are not considered to be reliable because projects by nature are transient and the company must constantly win new projects to generate additional revenue. These models have a broad range of profit margins based on the perceived value of services provided in any given market. Highly commoditized offerings can have low margins like reseller businesses while high-value specialized services could enjoy attractive margins in the 30%-40% gross profit range. Examples of highly specialized companies in the technology services industry include Accenture, Deloitte, Cognizant and NTT Data. We are also seeing some of these companies acquire software businesses to move up the value chain; Allied Advisers has advised two software companies on their recent exit to Accenture and Deloitte. Our report on The One Buyer You Did Not Think of for Software Companies would be of interest.

## 4. RESELLER MODELS

Companies that purchase products (software or hardware) for a cost and resell it for a profit have a reseller revenue model. Some examples of businesses that are resellers are Distributors, Value Added Resellers (VARs) and IT Staffing firms. Reseller businesses are typically characterized by high volumes and very thin profit margins, and technology differentiation is minimal. Some examples of well-known companies in this space are CDW, Ingram Micro and TD SYNNEX. The gross margins for reseller companies are typically in the 5%-15% range.

## BUYER AND INVESTOR PERSPECTIVES

It should be no surprise that the subscription model that yields the most reliable recurring revenue streams with the highest gross margins are most favored and valued by financial investors and strategic buyers. In fact, most Venture Capital and Private Equity funds will only consider investments in companies that have a subscription/recurring revenue model; within the software sector, SaaS businesses are the norm, and within services, managed services companies float to the top.

### Companies with subscription revenue models enjoy the highest valuation multiples in their industries.

We looked at two primary sectors within the technology industry:

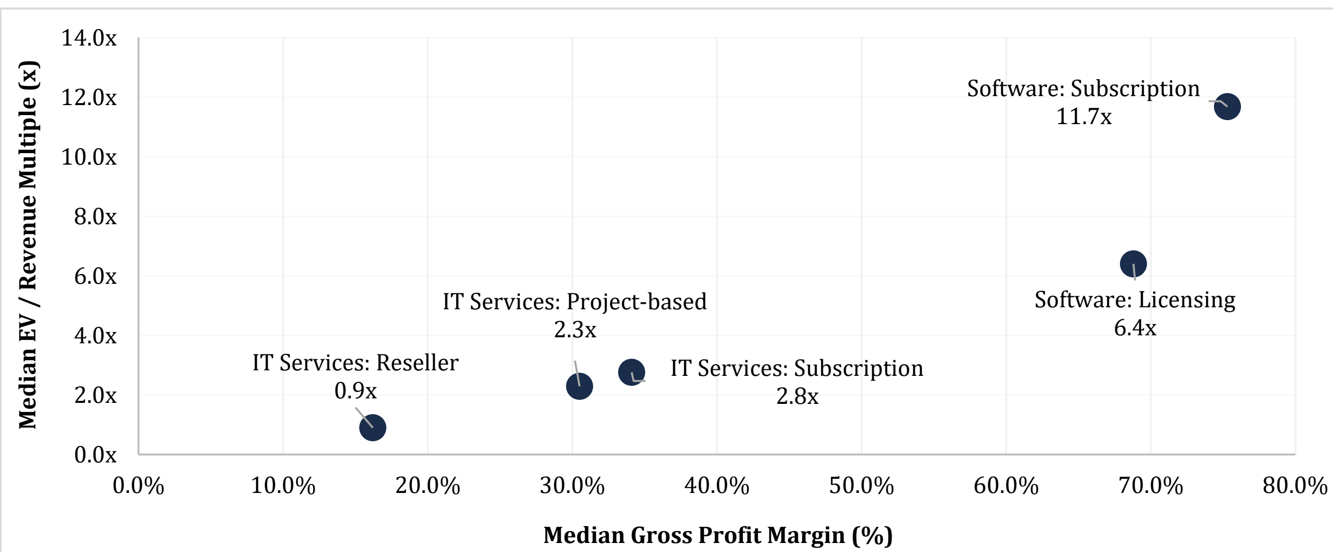
**(i) Software:**

a. Subscription model: SaaS businesses
b. Transactional/licensing model: traditional software companies selling software licenses

**(ii) IT Services:**

a. Reseller model: distributors and VARs
b. Project-based model: consulting and outsourcing companies
c. Subscription model: managed services companies

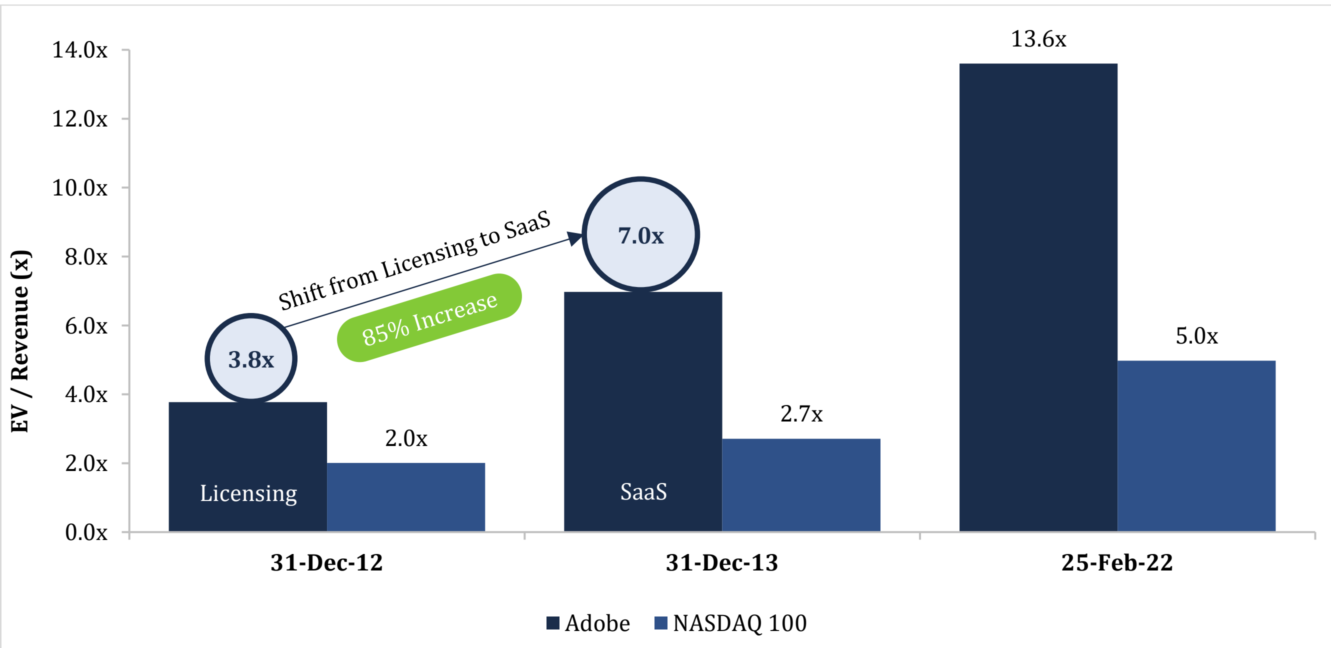
We examined the Gross Margin of representative companies in each of the above segments and charted the data against the revenue multiple that these companies are trading at on the public markets.




** Market/financial data as of March 3rd, 2022*
*Includes selection of leading companies in each category*

As evidenced in the above chart, software companies with a subscription (recurring) revenue model are trading at almost 2x the revenue multiple of software businesses with non-recurring revenues, a substantial premium in valuation. From an investor perspective, recurring revenue can be twice as valuable as non-recurring and doubles the enterprise value of a company for the same revenue. In the IT Services industry, managed services companies with subscription revenue also trade at a premium relative to businesses that have project-based revenue models.

Several software licensing companies have transitioned to SaaS businesses given the advantages of scalability, margins, strong customer demand and associated premium market multiples over licensing models. Adobe and Oracle are good examples of large companies which have done this. Adobe nearly doubled its valuation with the transition in May 2013 from selling licenses to subscriptions.




*Note: Adobe transitioned from a licensing to subscription model in May 2013*

## Summary and Takeaways

The nature of revenue models significantly impacts the interest and valuation consideration of investors and buyers, and should therefore guide entrepreneurs and executives in how they price their product and go to market. SaaS subscription models are distinctly more attractive for margins, scalability and enterprise value compared to alternative frameworks of revenue streams.

It is well known that there are significant differences in the value perception of software versus services revenue streams, as demonstrated in the chart above. It is worthwhile to note that sometimes customer contracts could in reality be providing recurring revenue, but the way they are written or structured may create the perception of services (e.g., managed services vs software). Companies should watch out for such nuances and structure contracts appropriately to mitigate confusion, and worse, affect valuation. Allied Advisers has been in situations where differences in the perception of revenue models have resulted in significant need for clarification and negotiation to ensure our sell-side clients get credit for the revenue streams.

Additionally, services can be tied with a SaaS business to create a moat, and if done correctly, can create additional value. Buyers and investors are generally fine with a small amount (10%-15%) of services (configuration, implementation, support, training, etc.) in the revenue mix of a software business if done profitably, as it can create stickiness with customers, reduce the friction of onboarding and create barriers to switching. On the flip side, companies without a SaaS model can look to expand their valuation by layering in SaaS offerings and be valued as Sum of the Parts (SOTP), leading to a more attractive blended enterprise value for the business.

Allied professionals have significant experience working with clients to optimize and negotiate valuation based on different revenue models in transactions. Please contact us for additional information.

## Allied Advisers: Investment Banking for Technology Companies and Investors

Ravi Bhagavan is Managing Director with Allied Advisers, a global technology-focused boutique advisory firm focused on investment banking for entrepreneurs and investors. The Silicon Valley-based firm, with a presence in Los Angeles, Israel and India, serves entrepreneurs and investors of technology growth companies globally on strategic advisory including M&A and capital raises. Allied Advisers bankers have completed technology transactions globally for clients with Fortune 50 buyers and top tier Private Equity firms. Contact: info@alliedadvisers.com