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## A Business Valuation May Not Accurately Reflect a Software Company's Value

**By Dave Kauppi, President, MidMarket Capital, Inc**

I can't tell you the number of times I have talked with owners of software companies that are very disappointed with a valuation performed by a qualified valuation professional. The purpose of this article is not to disparage this fine profession, but to point out the limitations of a process based on quantifiable metrics. Those metrics, industry comparables or Comps, and discounted cash flow are excellent valuation approaches for most traditional businesses. In addition to these metrics, many industries have established rules of thumb for valuations like 4 X EBITDA or 70% of the trailing twelve months' revenue.

If these metrics accurately function universally over a broad range of businesses, why don't they work for software companies? The most compelling difference is the exponential nature of the leverage of technology. In its most basic form, if you are making Widgets, to make your next Widget, you need the same amount of material, labor and capital. Yes, you can achieve some economies of scale, but those improvements are linear. This limitation naturally results in a narrow range of potential business valuation multiples.

Let's compare this with the exponential scalability of software assets. Once the software is written and stress tested by a core group of users, the cost for the next unit sold is almost \$0 for a digitally duplicated copy that is downloaded. To go from 100 users to 1 million users will require more staff, but it is not even close to the additional resources required for the same scaling in the manufacturing, distribution, services or retailing environment.

Software company owners that are approached by strategic buyers generally do not do a very good job of positioning their company to drive this strategic value. They will usually start with the argument that IBM or Microsoft or Google bought XYZ Competitor with \$300 million in revenues for \$1.2 billion. My company that is in the same space with sales of \$3 million should sell for \$12 million. The valuation of a large, brand name competitor is not translatable into a valuation for a small unknown company that provides a similar software. The buyers all know this and can immediately dismiss this potential seller as unrealistic.

Another limiting factor in the valuation puzzle is that finding relevant comps is very difficult with unique, small private companies. Privately held business owners do not want the public to know what they sold their company for and do not authorize the publication of that information. Unless the transaction is an acquisition by a public company and the deal value is large enough to be material and is required to be reported, no information about the transaction will be publicly available. So you can get the information on the \$1.2 billion transaction but generally will not get the metrics on a

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\$10 million deal. We are now back to the problem of the large company metrics that are not applicable to the very small company valuation.

In the discounted cash flow model, the analyst must project the cash flows out for five years and longer. To see the classic hockey stick growth actually captured in a financial model is an outlier for a typical valuation model. When a buyer analyzes this model they are generally resistant to accepting the high double digit or triple digit growth rates required to get the valuation that the owner deems appropriate.

Software company owners often put me on the spot and ask me for my opinion of value. I almost feel like the two realtors competing for a listing where the ethical guy says your house is worth \$925 K and the other guy says he can get \$1 million. The seller picks the \$1 million realtor and then the overpriced house sits on the market for eight months before being sold for \$880 K. The ethical guy could have sold it in three months for \$925 K.

A software business is way more complex. Even though I am flattered that the business owner is inviting my opinion, my answer is not supportable from a classic valuation metrics standpoint. I will rely on my experience with selling similar types of companies, the level of acquisition activity happening in the space, the value of the contractually recurring revenue, the availability of similar companies that could be substituted, the uniqueness of the solution, the sales resource required to scale, the time and cost to develop the solution internally, etc. We create a teaser and a memorandum where we package and highlight the strategic value drivers to the potential buyers.

When you see these high profile technology acquisitions and see that a relative start up with no profits and limited sales was acquired for \$250 million by Tech Giant A, do you think they just picked that number out and said to the seller, here you go? It looks easy and glamorous, but if the acquirer could have paid \$5 million, they sure would have. What was going on behind the scenes was the equivalent of a championship boxing match of M&A. Two or more qualified firms each saw tremendous value, growth, strategic fit and potential in this prize and did whatever they could to buy it as cheaply as the market would allow.

Here are a few examples of buyer negotiation approaches to help illustrate their every attempt to make an acquisition at the lowest price possible. Well, last year your sales were unusually high. I am just going to use the average of the last three years as my number. They recognize all of their software revenue when they make the sale. I am going to adjust my bid downward by the unearned income amount. I disagree with the amount you used for the owner's replacement salary in your EBITDA analysis. I am going to put in a fair market value number to come up with this reduced EBITDA number.

If the owner is trying to sell the business himself, he can usually only process one buyer at a time and thus these buyer negotiation tactics can be very effective. Likewise, if we only have one qualified buyer, it is very difficult to negotiate off these buyer positions.

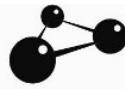
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However, in a professional M&A process, we design it to process several buyer pursuits in parallel. So when a buyer tells me they are going to just normalize the last 3 years' performance to lower their bid, I do not argue with them. My response is, you are certainly entitled to whatever methodology you want to employ to come up with your offer. Unfortunately your offer is no longer competitive with the marketplace. I will present this offer to my client, but I am pretty sure he will not counter sign your Letter of Intent.

So in the \$250 million company valuation example above, there were several very knowledgeable and talented representatives trying to buy as cheaply as possible and the market drove the valuation to a level that no valuation model in the world could have predicted.

A competitive M&A process will provide the ultimate company valuation. The decision now becomes, is it enough for me to sell?

Dave Kauppi is the editor of The Exit Strategist Newsletter and a Merger and Acquisition Advisor and President with MidMarket Capital, Inc. MMC is a private investment banking, merger & acquisition firm specializing in providing corporate finance and intermediary services to entrepreneurs and middle market corporate clients in information technology, software, high tech, and a variety of industries. Dave began his Merger and Acquisition practice after a twenty-year career within the information technology industry. His varied background includes positions in hardware sales, IT Services (IBM's Service Bureau Corp. and Comdisco Disaster Recovery), Software Sales, computer leasing, datacom, and Internet. The firm counsels clients in the areas of merger and acquisition and divestitures, achieving strategic value, deal structure and terms, competitive negotiations, and "smart equity" capital raises. Dave is a Certified Business Intermediary (CBI), is a registered financial services advisor representative and securities agent with a Series 63 license. Dave graduated with a degree in finance from the Wharton School of Business, University of Pennsylvania. For more information or a free consultation please contact Dave Kauppi at (630) 325-0123, email [davekauppi@midmarkcap.com](mailto:davekauppi@midmarkcap.com) or visit our Web page <http://www.midmarkcap.com>

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