TRENDING TOPICS

LENDING MODELS EVOLVING TO MEET NEEDS OF FAST-GROWING SaaS MARKET

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Software as a service (SaaS) companies, emerging with the advent of the cloud, represent one of the fastest-growing industries today, and yet young SaaS companies have had to rely on some of the most expensive financing around, venture capital.

Where are the banks?

While many of the better known SaaS companies have grown into very large enterprises, the vast majority of SaaS companies are small to mid-sized. In fact, Forrester Research estimates will reach $106 billion in revenues in 2016[1] — are small to mid-sized businesses.

"Despite the fact that SaaS businesses typically require less cash to grow and costs rarely fluctuate, conventional banks — rooted in their 20th-century lending practices — are rejecting these 21st-century startups because they have an entirely different financial profile than most other companies," writes BJ Lackland, CEO of Seattle's Lighter Capital — an investor in early growth stage software, SaaS and tech services businesses — in a *Wired Innovation Insights* blog.[2]

SaaS companies are lacking when it comes to the key measuring sticks that banks use to determine creditworthiness, namely inventory and receivables, he says. Their inventory tends to be cloud-based and therefore a nontangible asset, and receivables are subscription-based and often amortized. In contrast, banks prefer borrowers to have "traditional" receivables in which customers are billed and expected to pay in typically 30 or 60 days.

When evaluating SaaS companies, "traditional bankers find it enormously difficult to justify the perceived risk on their balance sheets — it's just not the way they do business," Lackland says.

NEW EVALUATION METRICS EMERGE

However, some banks today are stepping up to the dynamic SaaS market by using different metrics to gauge credit quality. The arrival of banks is important for SaaS companies, because using expensive venture-capital financing often requires them to give away too much of the store.

SaaS companies can burn through significant cash early on in search for customers, another obstacle from a risk perspective for traditional bank lenders. On the other hand, by pulling aboard new subscribers, who are billed monthly or annually, SaaS companies create impressive future revenue streams. Subscription revenue tends to be "sticky" in that it improves customer retention and provides healthy profit margins.

Predictable, long-term billing streams enable SaaS businesses to lower their A/R balances while maintaining a more stable overall business. The steady inflow of monthly subscription revenue enables SaaS firms to avoid the seasonal "feast or famine" cash flow fluctuations of the traditional enterprise model. Thus, banks are creating financing models that allow SaaS companies to borrow at a multiple of their monthly recurring revenue.

Banks providing such financing will analyze the quality of the recurring revenues using metrics such as the cost to acquire new customers and the lifetime value of those customers.

If a SaaS firm enjoys growing recurring revenue, it likely will have a low customer turnover rate. That in turn will result in a higher lifetime customer value and more manageable customer acquisition costs. This enables a bank lender to assign a lending multiple to the monthly recurring revenue stream that can justify a more attractive line of credit.

RETAINING MORE EQUITY CONTROL

Lighter Capital's Lackland reports that with revenue-based financing there are no personal guarantees by firm principals or the need to secure the loan with hard assets, and principals can retain more equity control than they can with venture capital financing.

"A [revenue loan] is long-term growth capital," Lackland says. "Repayments are a fixed percentage of your monthly revenues, so they rise and fall with the ebb and flow of your business."

Lending expertise among SaaS is critical. Companies considering this type of financing should seek strong lending expertise leveraging the recurring revenue model that have a verifiable track record of success. In addition, they should thoroughly know their recurring revenue stream patterns and be able to track their customer acquisition costs and the lifetime value of each customer.

The Technology Finance group at PNC Business Credit offers senior secured financing for sponsor-backed SaaS companies. If you have a deal that needs to get done, learn more about our track record and reliable capital solutions at pnc.com/donedeal.

1 "Roundup of cloud computing forecasts and market estimates, 2015," *Forbes*, Jan. 24, 2015, http://www.forbes.com/sites/louiscolumbus/2015/01/24/roundup-of-cloud-computing-forecasts-and-market-estimates-2015/

2 *Wired Innovation Insights* blog, Nov. 28, 2014, http://insights.wired.com/profiles/blogs/why-bank-lending-is-a-pain-in-the-saas#axzz3ij3HFxwC

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