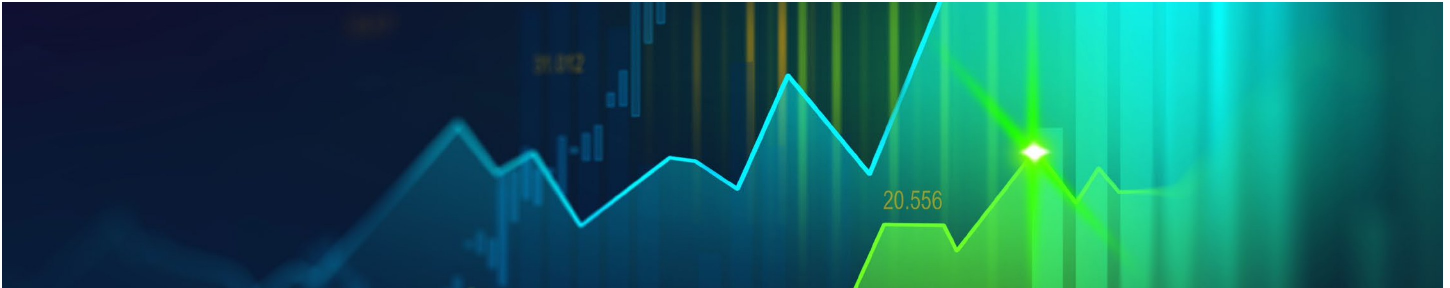
Adams Street

The Enduring Appeal: How Top Companies Command High Valuations



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KEY TAKEAWAYS

- Premium valuations for growth stage companies are largely driven by their ability to demonstrate efficient growth through key metrics
- Sales efficiency metrics for "best-in-class" software companies have eroded since 2021 due to increased buyer scrutiny
- Growth remains paramount for investors and faster growing companies will continue to command premium valuations in any market environment
- As market valuations begin to stabilize and companies grow into their previous multiples, the investment climate is improving, creating opportunities for investors to partner with businesses demonstrating strong, efficient growth

When analyzing growth stage company valuations, key metrics to consider include vertical, market size, topline revenue growth, long-term profitability potential, and sales efficiency.

Many investors continue to prioritize a company's ability to grow revenue sustainably over its ability to generate free cash flow in the near term, a topic we touched on in our recent paper on why founders should consider embracing a **down round** if doing so can help keep growth on track.

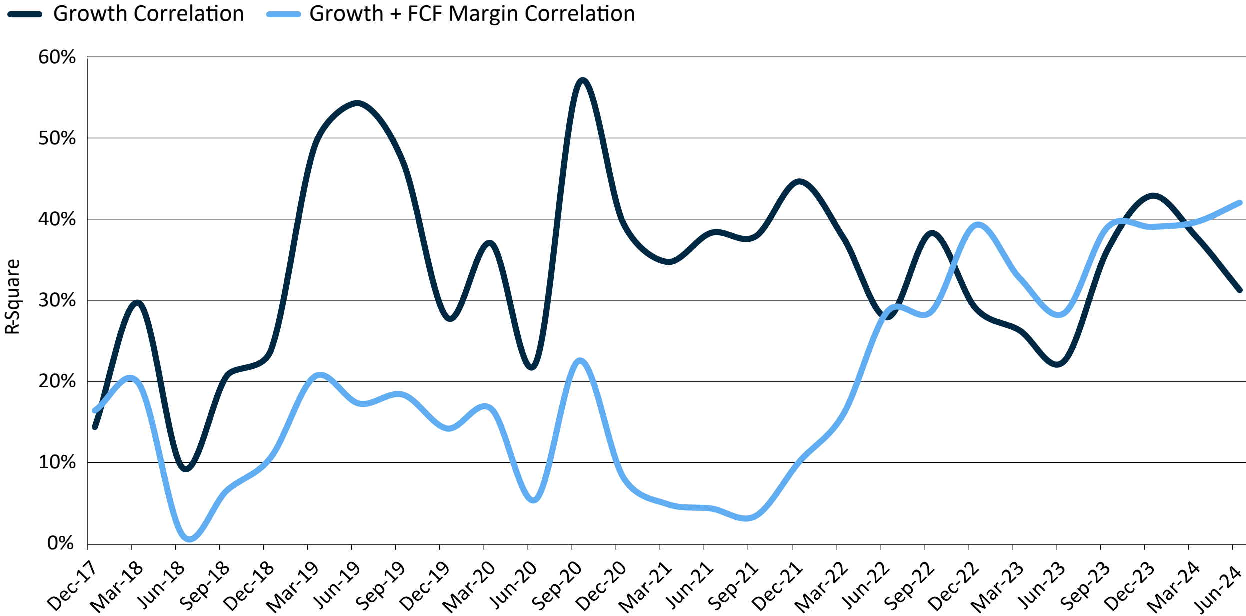
Companies seeking to command a premium valuation in the current market need to show strong, sustainable and efficient growth, demonstrated by key performance indicators and sales efficiency metrics

Revenue growth is valued so highly in today's market because the software industry has provided a proven economic model over recent cycles. This model relies on high gross margins and strong operating leverage once the company reaches scale, and can translate current growth into much larger profits down the road. Investors therefore have been ascribing premium valuations to companies they believe can demonstrate strong, sustainable growth.

A guiding principle for many investors when it comes to the trade-off between growth and cash burn is the Rule of 40 – revenue growth rate plus free cash flow (FCF) margin, which ideally should be 40% or higher. The mix of the figures can vary depending on where a company is in its lifecycle. For example, we believe that for many investors, a company with a 50% year-over-year revenue growth rate and (10%) FCF margin would likely be valued at a higher multiple than a similar company at the same scale but with a 10% year-over-year revenue growth rate and 30% FCF margin, because the superior top-line growth of the former gives it the potential to drive significantly more profit in the long term.

Figure 1 examines the correlation (r-square) between valuation and growth, as well as valuation and growth plus FCF margin for a selection of public technology companies.

Figure 1: Correlation Between Valuation and Growth Versus Valuation and Rule of 40[1]



Increased Scrutiny on Spend

While investors still place outsized importance on revenue growth, especially for early-stage businesses, the spread between the correlation of valuation multiple to growth and valuation multiple to Rule of 40 has tightened recently, signifying an increasing focus on efficient growth.

As a result, we are seeing additional metrics that multiply revenue growth by a specific factor to get to an adjusted Rule of 40.

Companies seeking to command a premium valuation in the current market therefore need to show strong, sustainable and efficient growth, demonstrated by key performance indicators and sales efficiency metrics.

Investors want to see a clear return on investment from sales and marketing spend and use a number of metrics to evaluate the efficiency of this activity.

We have seen a number of efficiency metrics adopted in the enterprise software sector in recent years, as well as shifts in how those metrics have trended since 2021. Ranges provided for these metrics are based on our observations of typical levels seen in the private markets industry during diligence on potential company investments and fundraising.

Magic Number

Magic Number quantifies how many dollars of annual recurring revenue (ARR) are generated for every dollar spent on sales and marketing.

The investment industry generally believes that the benchmark for a good Magic Number is 0.7-1.0x.

In 2021, a pull-forward in enterprise software spend led to Magic Numbers of 1.2x plus for companies we viewed as being attractive investment targets. However, as companies scrutinize software and broader technology spend more heavily, businesses we are evaluating today and remain excited about tend to have a Magic Number around 0.7x.

Customer Acquisition Cost (CAC) Payback Period

CAC Payback Period takes Magic Number a step further by assessing how many months it will take to recoup the upfront sales and marketing spend needed to acquire customers after adjusting for gross margin.

At the market peak in 2021, CAC Payback Periods for our top investment targets serving small and medium-sized businesses (SMB) and enterprise customers were eight and 16 months, respectively. Today we are seeing well-positioned companies that have payback for SMB and enterprise customers at around 14 and 24 months, respectively.

Lifetime Value to Customer Acquisition Cost (LTV to CAC)

This ratio assesses the long-term value that a customer brings, relative to the cost of acquiring them. It goes a layer deeper than Magic Number and CAC Payback Period by factoring in expected lifetime of a customer and expansion of customer spend during that time.

Three years ago, we found that the most compelling companies for investment often boasted three-year LTV to CAC ratios exceeding 5x, reflecting strong customer retention and high upsell. In the current market, however, we are seeing a normalization of these ratios, with many of the top companies now showing three-year LTV to CAC figures closer to 3x.

Burn Multiple

Burn Multiple compares net new ARR generated over a period to net cash burn over that same period. This is helpful in evaluating the overall sustainability of a company's growth trajectory as it factors in all cash costs.

In 2021, a "growth at all costs" mentality from businesses resulted in the Burn Multiple for some companies ballooning to as high as 4.0-5.0x or more.

The most attractive companies we diligenced in 2021 had Burn Multiples of around 1.0x, which has come down to 0.7x today, demonstrating the increased focus on efficient operations.

Public Market Multiple Trends

Since peaking in early 2021, public market multiple valuations in several sectors have declined by more than 77% on average,[2] as shown in Figure 2, in large part due to the impact of variables such as inflation and rising interest rates. This decrease led to a wide delta in the valuation expectations of buyers and sellers during most of 2022 and into 2023, given that many companies were still seeking the high valuations experienced in 2020 and 2021. This valuation expectation delta substantially slowed the pace of deal making over the past two years.

Figure 2: Public Market Valuation Multiples Decline Sharply Since 2021 Peak[2]

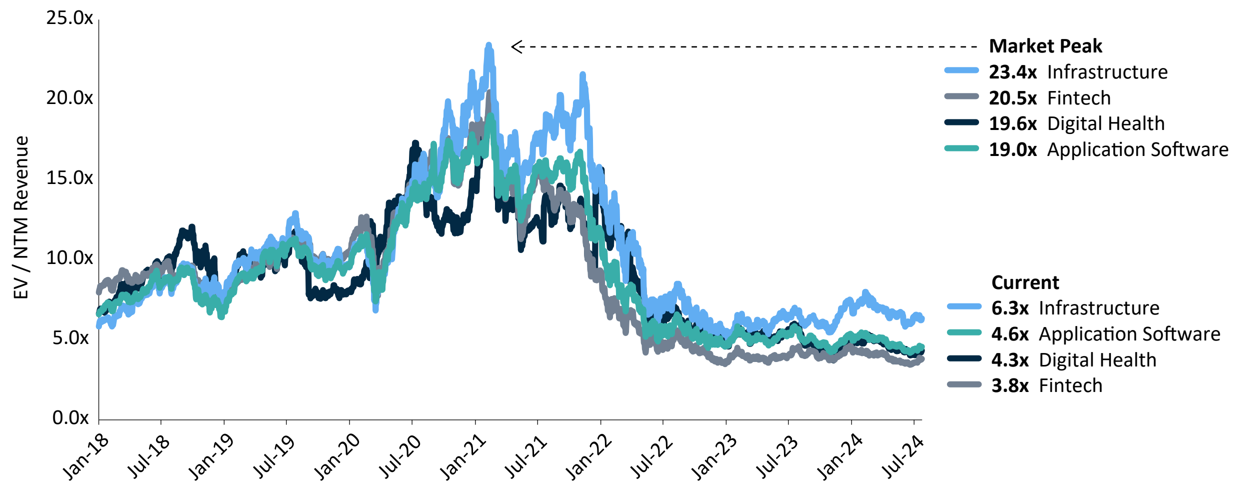
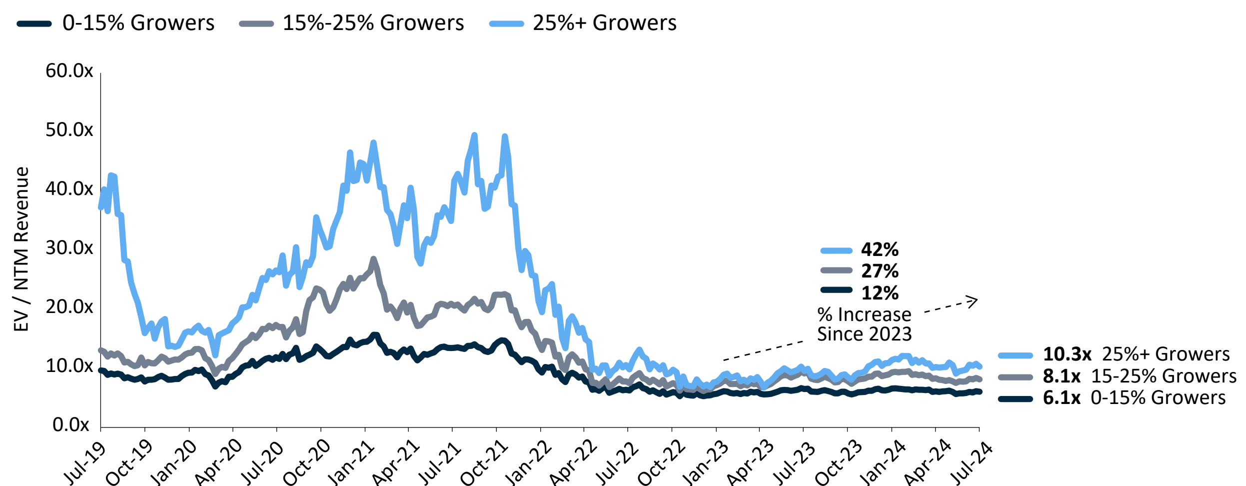


Figure 3 illustrates the premium multiple that high growth companies have commanded over recent years. The gap in valuation multiple has tightened recently between companies growing revenue at an average annual rate of 25%+ (High Growers) and companies growing revenues at a slower annual pace; however, the graph shows that High Growers commanded an average valuation premium: (i) more than 25% higher versus companies growing revenue at 15-25% (Medium Growers) over the past five years, and (ii) more than 70% higher than companies growing revenue at 0-15% (Low Growers) over the relevant period.

The valuation multiples of High Growers also tend to recover faster when expectations normalize, as also shown in Figure 3. Since the beginning of 2023, multiples for High Growers increased by 42% on average, while multiples for Medium and Low Growers increased by 27% and 12%, respectively, on average.

Figure 3: High Growth Companies Command Premium Multiples Across Cycles[3]



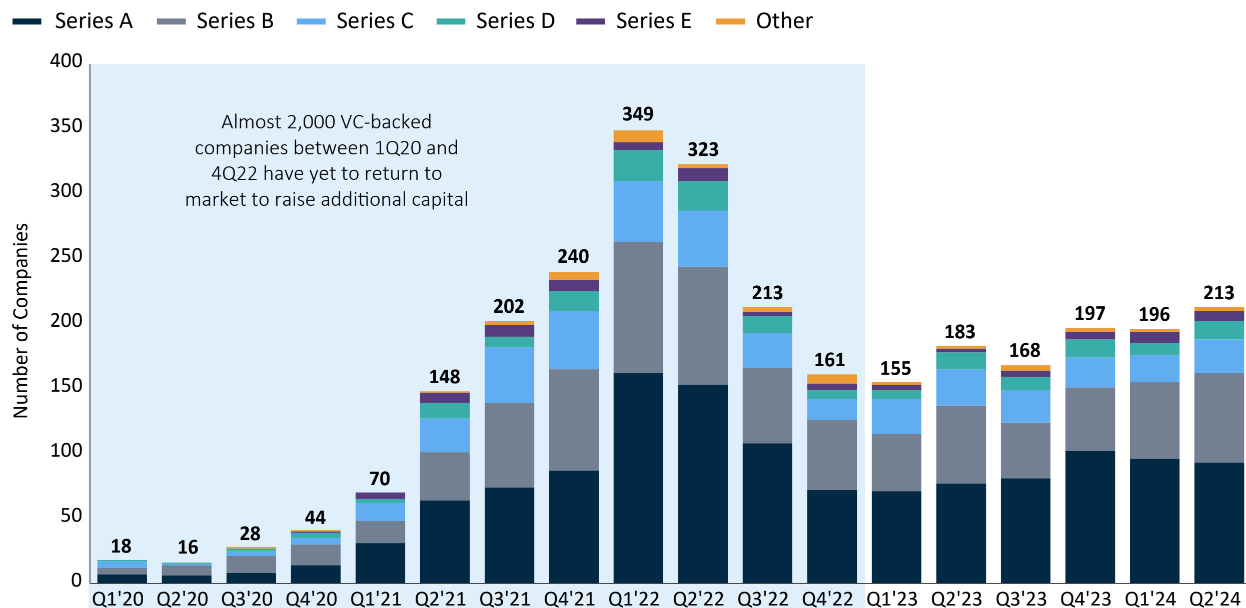
Ripe Funding Market with Several Pockets of Opportunities

In the growth equity universe, a new batch of companies has now gone through their typical funding cycle in the recent more "normalized" valuation multiple environment.

There is also a cohort of companies that raised at elevated multiples in 2021 and now wants to raise additional funding to keep revenue growth on track. Figure 4 shows that there are more than 1,800 venture backed companies that have not raised capital in the past 18 months.

We believe many of these companies are strong businesses that have learned how to navigate various market environments, have grown their revenues into their prior round valuations, and can ultimately be attractive fundraising targets that still command a premium valuation due to their underlying metrics. The venture funding environment started to improve in early 2024 and we believe that more opportunities to invest in healthy companies will present themselves in the coming months and beyond.

Figure 4: Growth Equity Capital Demand is Likely Set to Increase[4]



Improving Deal Environment

The gap in valuation expectations between potential investors and companies presented a challenge to deal making in 2022 and 2023. As multiples have begun to normalize and companies have had time to mature into their previously high valuations, the deal environment has begun to pick up again.

Today, companies that are able to show efficient revenue growth in large markets through strong business metrics continue to be rewarded with healthy valuation multiples. Investors remain eager to pay up for companies they believe have durable long-term growth potential.

Adams Street remains optimistic about the long-term potential for technology companies and that an increasing number of verticals are ripe for disruption. We remain excited to partner with the best companies through any market cycle because we believe iconic businesses can be created at any time. ■

1. Source: Public company data from Capita IQ as of July 2024 based on a set of 115 technology companies determined by Adams Street to be representative of broader market trends and that were public as of 12/31/2022 (although some companies have since been acquired and delisted), including notable names such as ADBE, AI, BILL, BOX, CFLT, CRWD, DBX, DDOG, FTNT, GTLB, IOT, MDB, MNDY, MSFT, NET, NOW, OKTA, PANW, PLTR, S, SHOP, SNOW, WDAY, ZS.
2. Source: Public company data from Capital IQ as 7/23/2024 based on a set of 207 healthcare, fintech, infrastructure and application software companies determined by Adams Street to be representative of broader market trends; Digital Health includes: AGL, CERT, DH, DOCS, OSH, PEAR, SDGR, TDOC, VEEV, among several others. FinTech includes: AVDX, BILL, BLND, BTRS, CLOV, COIN, COUP, DOMA, ENVA, EVER, EXFY, FLT, GLBE, GPN, HOOD, LDI, MELI, MQ, NCNO, NU, OLO, OPEN, PAGS, PYPL, RKT, ROOT, SQ, STNE, TOST, WISE, among others. Infrastructure includes: AYX, CFLT, CRWD, DDOG, FROG, FTNT, GTLB, IOT, MDB, NET, PANW, S, SNOW, SPLK, TENB, ZS, among others. Application Software includes: AMPL, BAND, BIGC, BILL, BOX, CRM, CXM, DBX, DOCU, EXFY, FIVN, FRSH, HUBS, INST, INTA, LAW, MNDY, PAYC, PCOR, PCTY, PYCR, QTWO, SHOP, SQSP, TOST, VEEV, WDAY, ZUO, among others.
3. Source: Public company data from Capital IQ as of 7/23/2024 based on a set of 117 technology companies determined by Adams Street to be representative of broader market trends, including notable names such as: ADBE, AI, BILL, BOX, CFLT, CRM, CRWD, DDOG, DOCU, FTNT, GTLB, HCP, HUBS, IOT, MDB, META, MNDY, NET, NOW, OKTA, ORCL, PANW, PAYC, PCOR, PLTR, S, SHOP, SNOW, TEAM, TENB, TOST, TWLO, WDAY, ZOOM, ZS.
4. Pitchbook data as of 7/23/2024. Includes a global list of private software companies that had their most recent round of fundraising from 1/1/2020 to 6/30/2024. Includes only companies where the company's valuation after their most recent financing round was $20 billion or less, and where the total amount of money raised in the most recent financing round was at least $10 million.

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