Valuing Software Companies and Software Assets Advanced Techniques and Tales from the Trenches

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Many Very Different Viewpoints

- Public or Private Company?
  - If public, share price is relevant
- Investor
  - Depends on their risk attitude and goals
- Buyer
  - Depends on relative sizes of companies
- Seller
  - Depends on relative sizes of companies

Assets and Liabilities

- Tangible
  - Contracts
  - Balance Sheet
  - Performance
- Intangible
  - Intellectual Property
  - Skill of staff
  - Competitive position
  - Value of customers

Assets and Liabilities What's Difficult to Compute?

- Tangible
  - M Contracts
  - E Balance Sheet
  - E Performance
- Intangible
  - H Intellectual Property
  - M Skill of staff
  - M-H Competitive position
  - M-H Value of customers

E = "easy" to compute
M = medium difficulty to assess
H = "hard" to compute and assess

Robert’s Rules of Software Value*

* But you’ve heard them all before

1. The last transaction sets the value.
2. Investors with ready cash set the value.
3. Competition is a good thing – validates the market.
4. Customer lists have no long term value.
5. Mature technology is a declining asset.
6. The bleeding edge needs deep pockets to realize value
7. Strategic value is huge.
8. Patents have value if you can defend them.
9. No one likes “hockey stick” forecasts.
10. Human capital has value if it can be retained.

Robert’s Secondary Rules of Value*

* But you’ve heard them all before

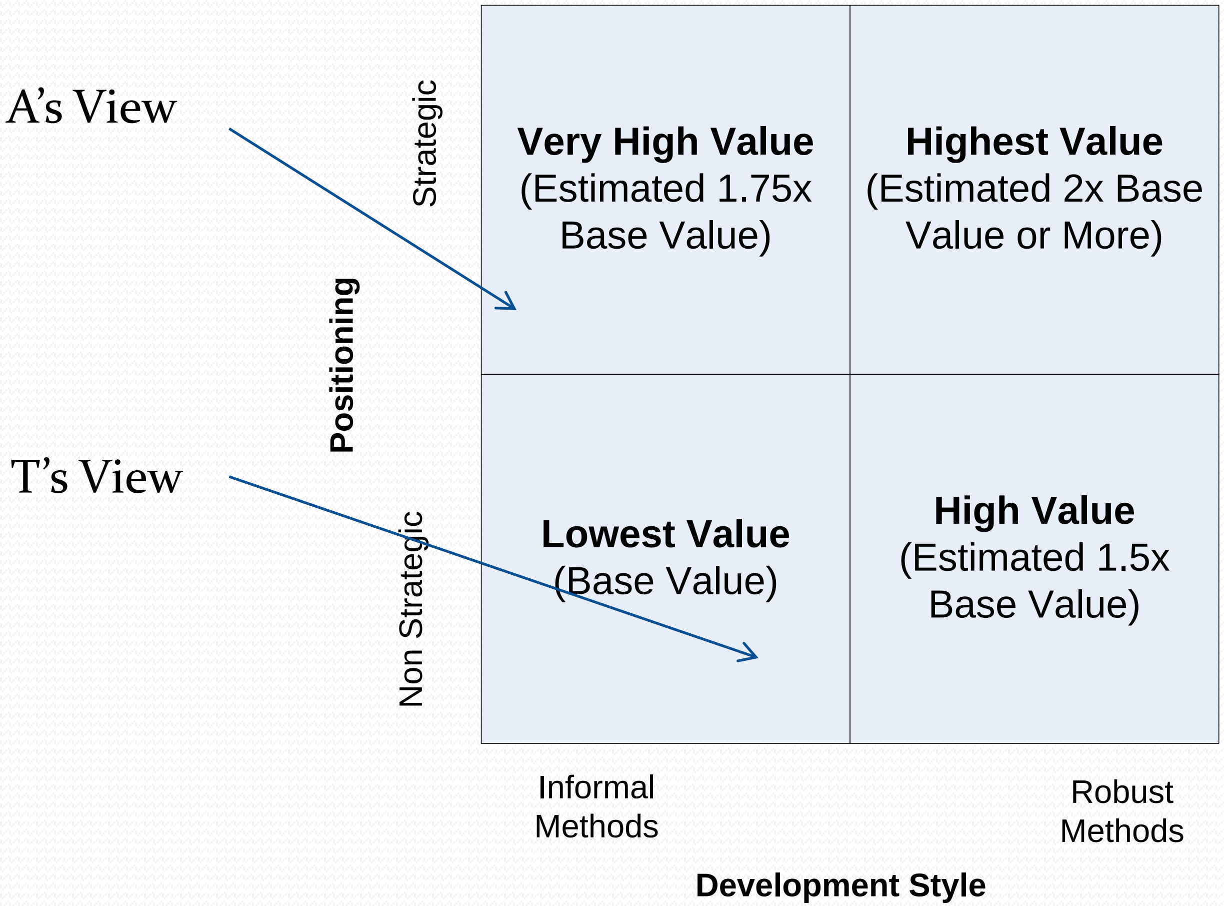
1. Never rely only on a forecast and DCF to set value
2. Comparables are interesting but can’t be used alone
3. Forecasts set by sales people are worrisome
4. Exploitable tax credits are worth about 10% of book
5. Good will has no value
6. Use marketing $ to get customers – don’t buy them
7. Lines of code can’t be used for valuation
8. Sunk development costs to date measure value
9. Always try to leave debt behind
10. Technology without a business has low value

Example 1

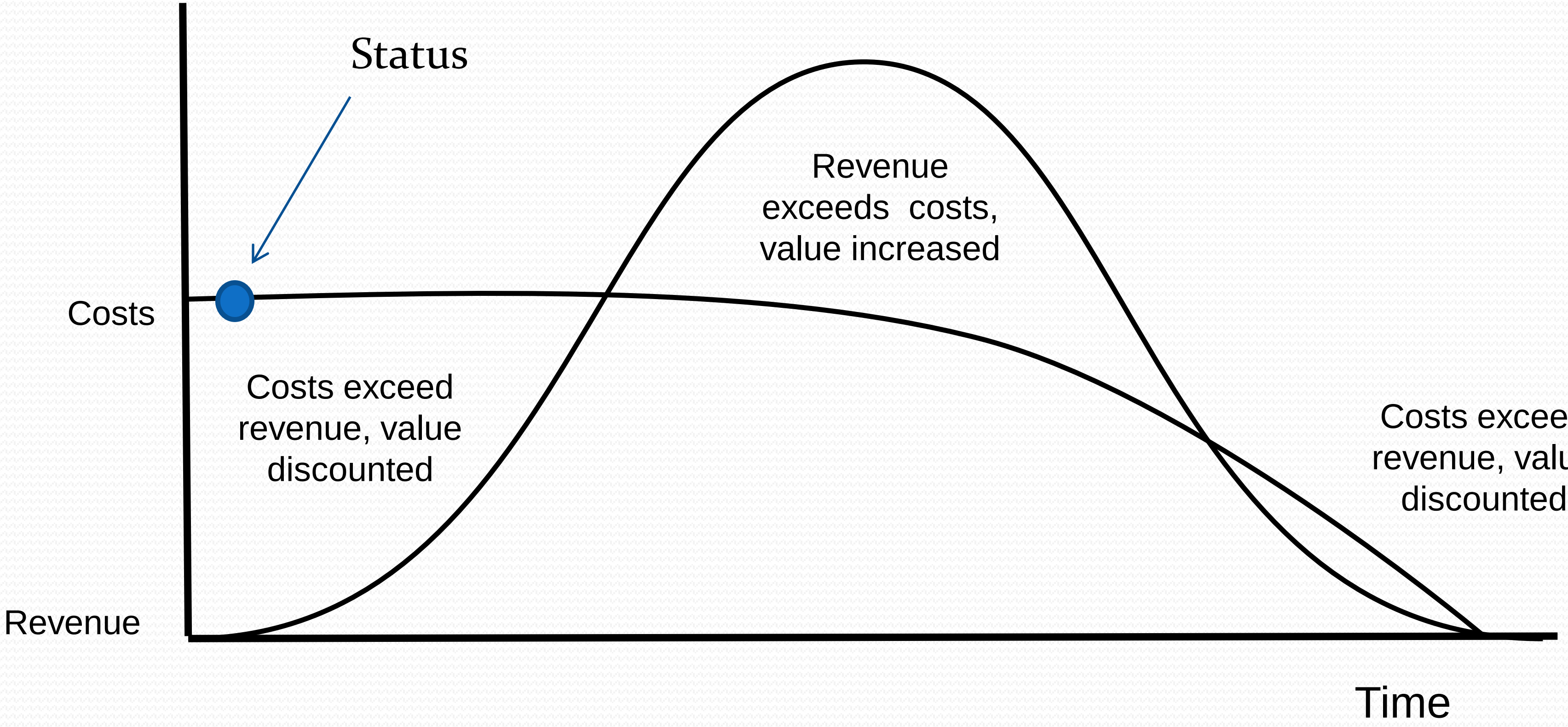
- Large public Fortune 500 software firm (A) wants to acquire a small company (T) for its unique, early stage technology – can bring A to market faster.
- T has almost no customers or revenue, has a negative balance sheet and expects losses for several more years – Is there value here?
- T has the world's best technology in a specific area, and skilled staff – What is the value of the IP?
- A decides to raid T for staff and not to buy the company – a small purchase price would be more trouble than it was worth. With the staff, it would be easier to build an equivalent technology.
- A fails to attract the staff
- T sells to another public company at break even for the investors.
- T later conceded that they would have accepted any offer from A, as they were selling furniture to make payroll!

- Lessons: A did not recognize the strategic value and T did not market itself when it had the opportunity. The value was there, but lost in a failed transaction and missed communication.

Position vs. Development Style



Software Value Lifecycle Curves



Example 1 – Valuation Methods

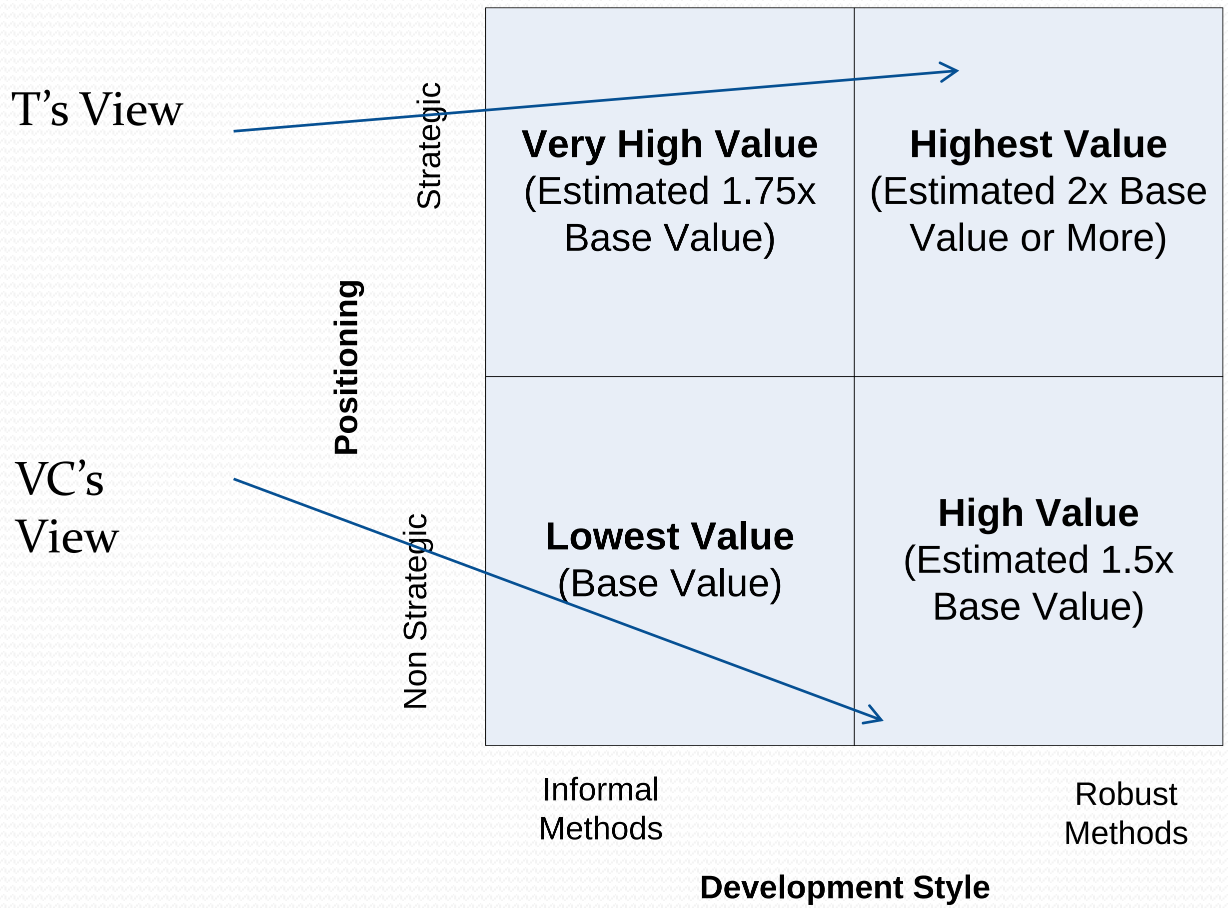
- Acquiring Company - A
  - Buy vs. Build calculation
  - Forecast with and without T
  - Cost/benefit of raiding staff from T
  - Normal balance sheet calculations and impact on A's stock price
- Target Company – T
  - Had internal forecasts from investment rounds – far too high
  - Internal expectations set too high
  - No experience in negotiation, and no real valuation completed

Example 2

- Small software start-up (T), pre-revenue, post development seeks VC funding. Previously angel funded. Selling enterprise-level software.
- VC's take T's modest revenue forecasts, and reduced by 75%. VC's expected long sales cycles.
- VC's forced all debt off the balance sheet, including deferred salaries.
- T had no patents, no competitors.
- VC's invested at a low valuation with T's and C's that gave them preference.
- VC's forced in a new CEO, turned aside T's choice of sales team.
- Two years later, still no sales, company insolvent, closes down.

- Lessons: T had no ability to negotiate and VC's used this advantage. T should have gone back to angels for deeper investment and hired its chosen sales people.

Position vs. Development Style



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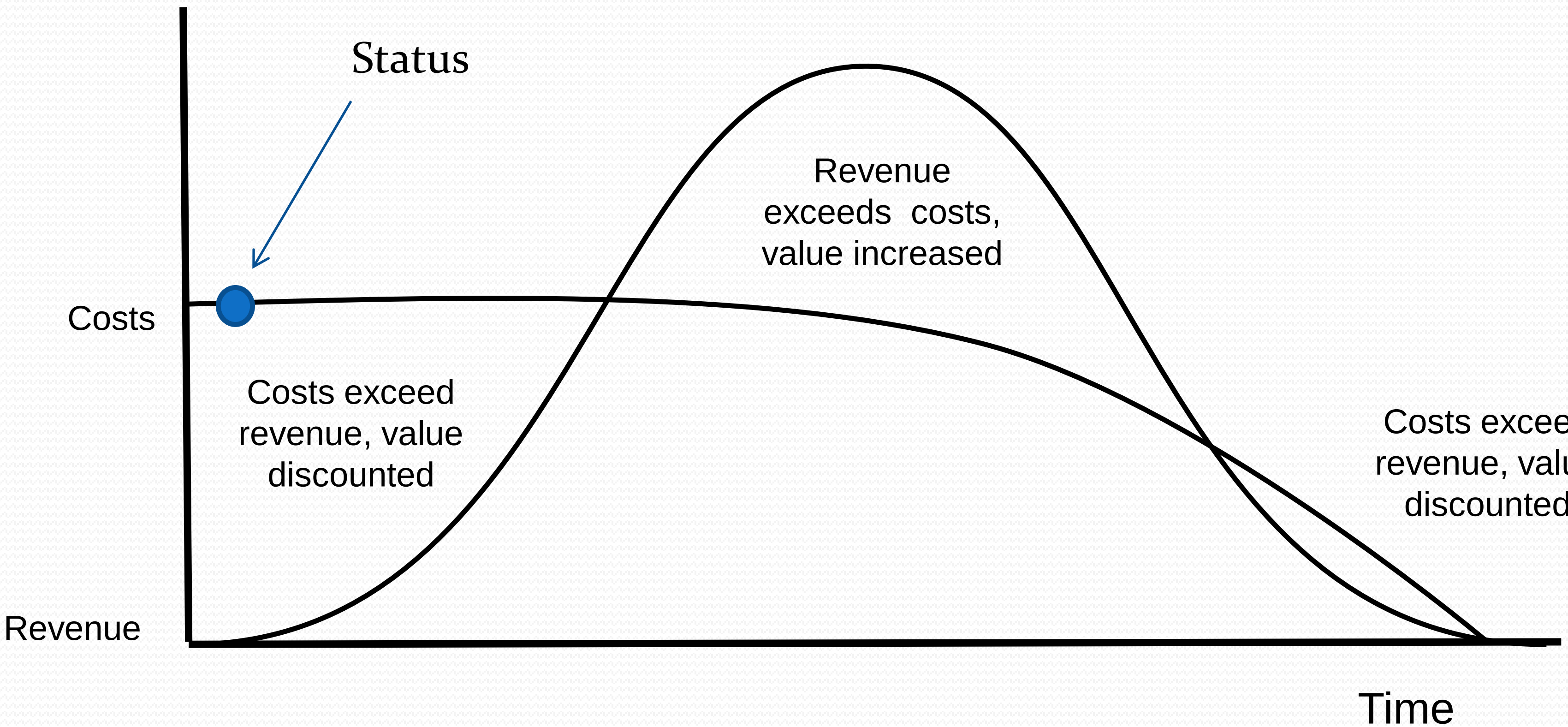


Example 2 – Valuation Methods

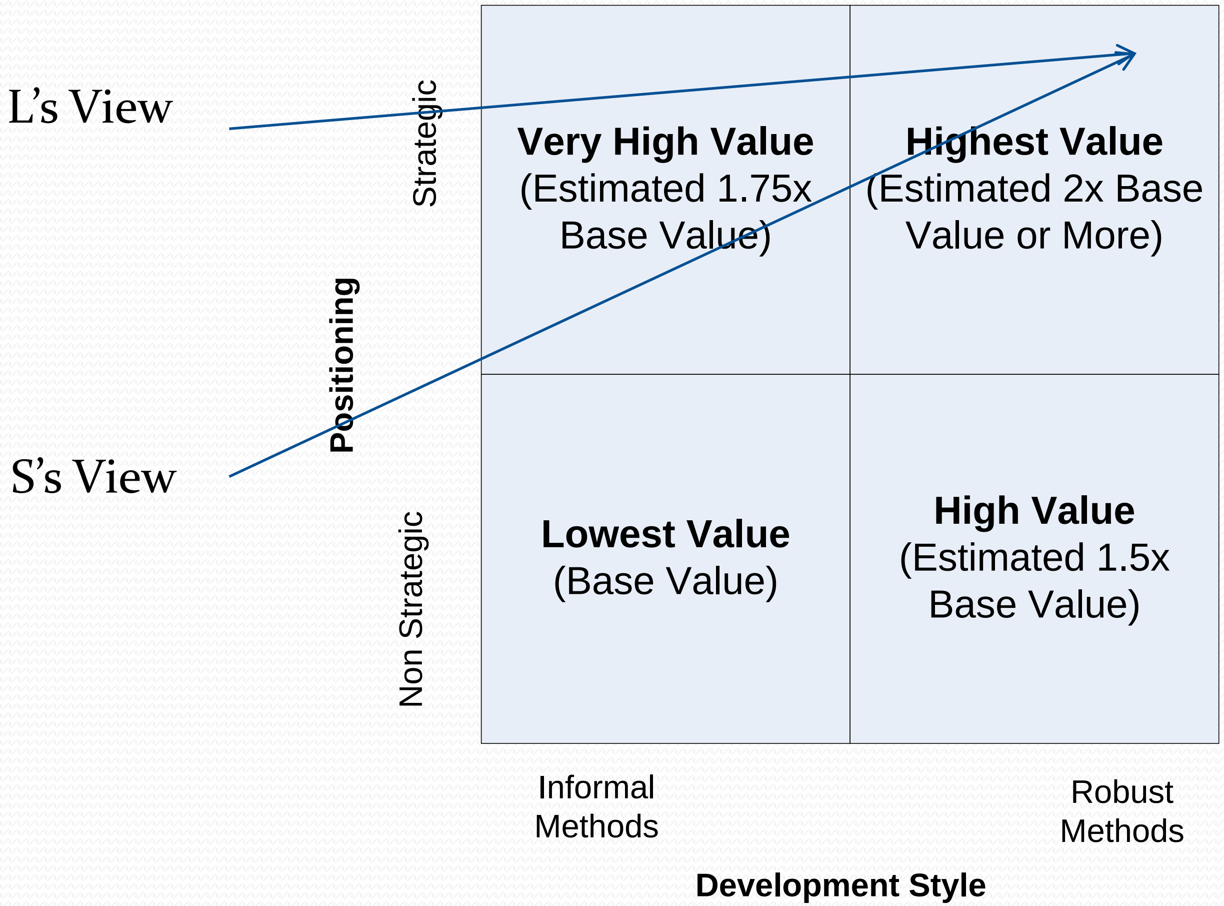
- VC's
  - Forecast by discounting T's view
  - Decreased risk by choosing own CEO
  - Removed all debt before investment
- Target Company – T
  - Had internal forecasts from angel investment rounds – far too high
  - Internal expectations set too high
  - Desperate for funds, had no choice in their view

Example 3

- Small niche software company (S) with $30M revenue and slightly positive EBITDA seeks a buyer. Builds a positive forecast, but customizes its forecast to the potential of several large target acquirers.
- Large acquirer (L) enters negotiations. Sees the strategic advantage of owning the technology.
- L paid $365M for S – with essentially no history of EBITDA
- S had small debt, but not an issue with this price.

- Lessons: S understood how to market and value their company. They designed it to be sold. L knew how to value the advantage that owning S would provide.

Position vs. Development Style



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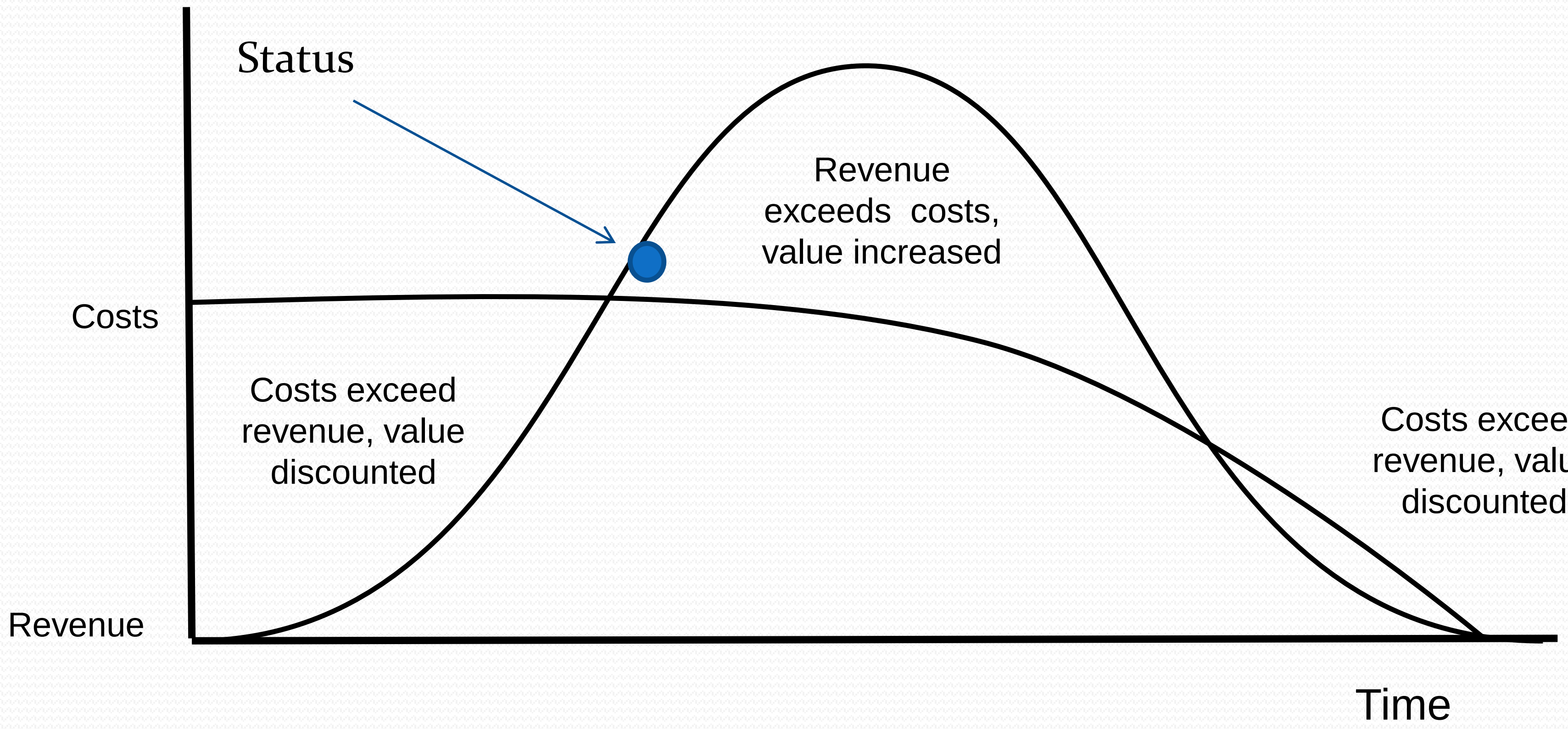


Example 3 – Valuation Methods

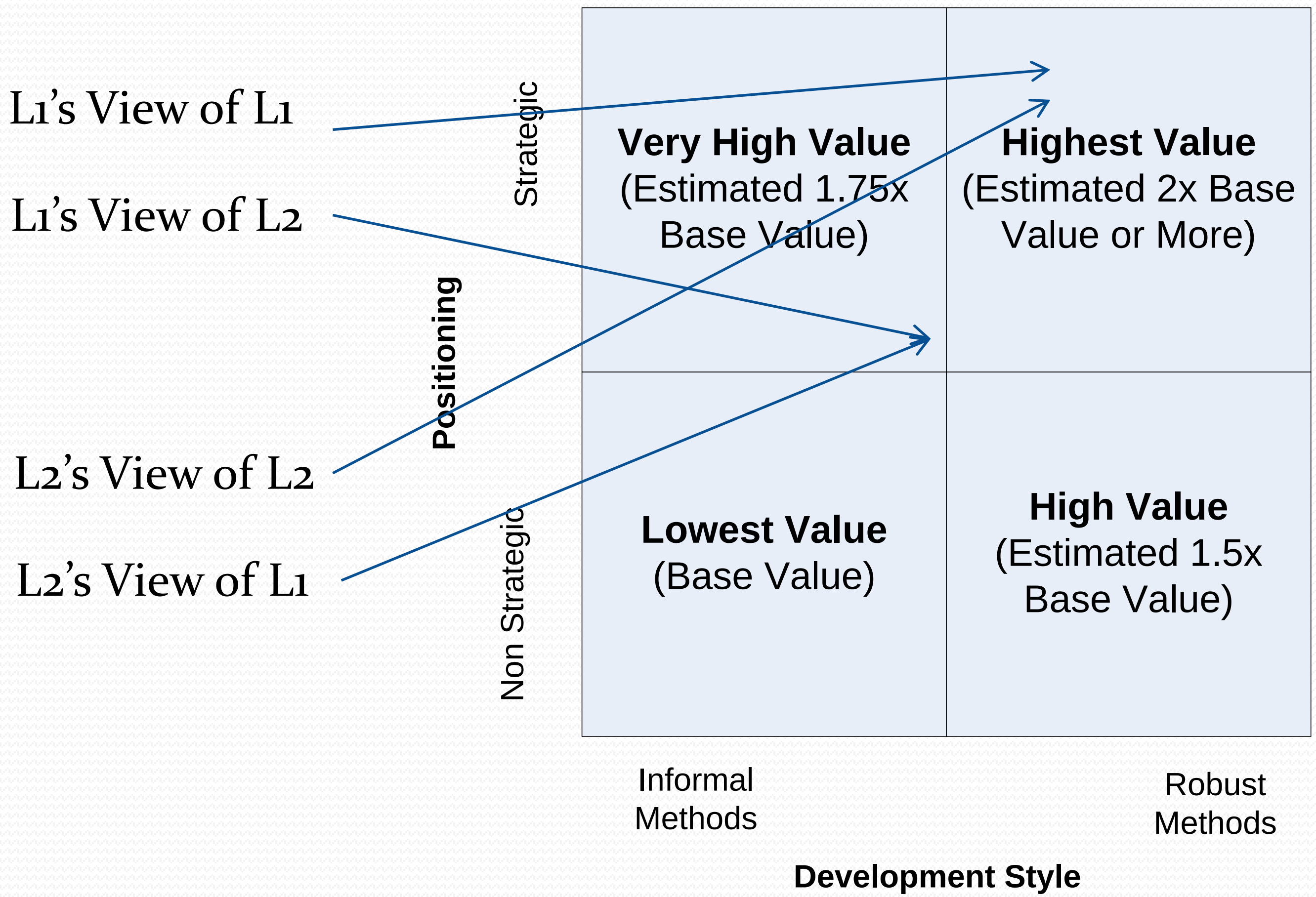
- Small Company - S
  - Forecasted with understanding of L's potential
  - Sold management team as well
  - Removed all debt before investment
- Buyer– L
  - Understood the strategic value
  - Buyer and seller matched expectations
  - Had fear of S falling into competitive hands and paid for solving this fear.

Example 4

- Large public software company (L1) sees a benefit to merging with its largest competitor (L2), also public.
- L1 valued L1 as higher than L2 based on DCF
- L2 valued L2 as higher than L1 based on DCF
- Argued over whose customers were most important, and whose products were more important
- Could not agree, no deal was consummated.

- Lessons: Neither side sufficiently motivated. Never should have started talking, as now know too much about each others' businesses.

Position vs. Development Style



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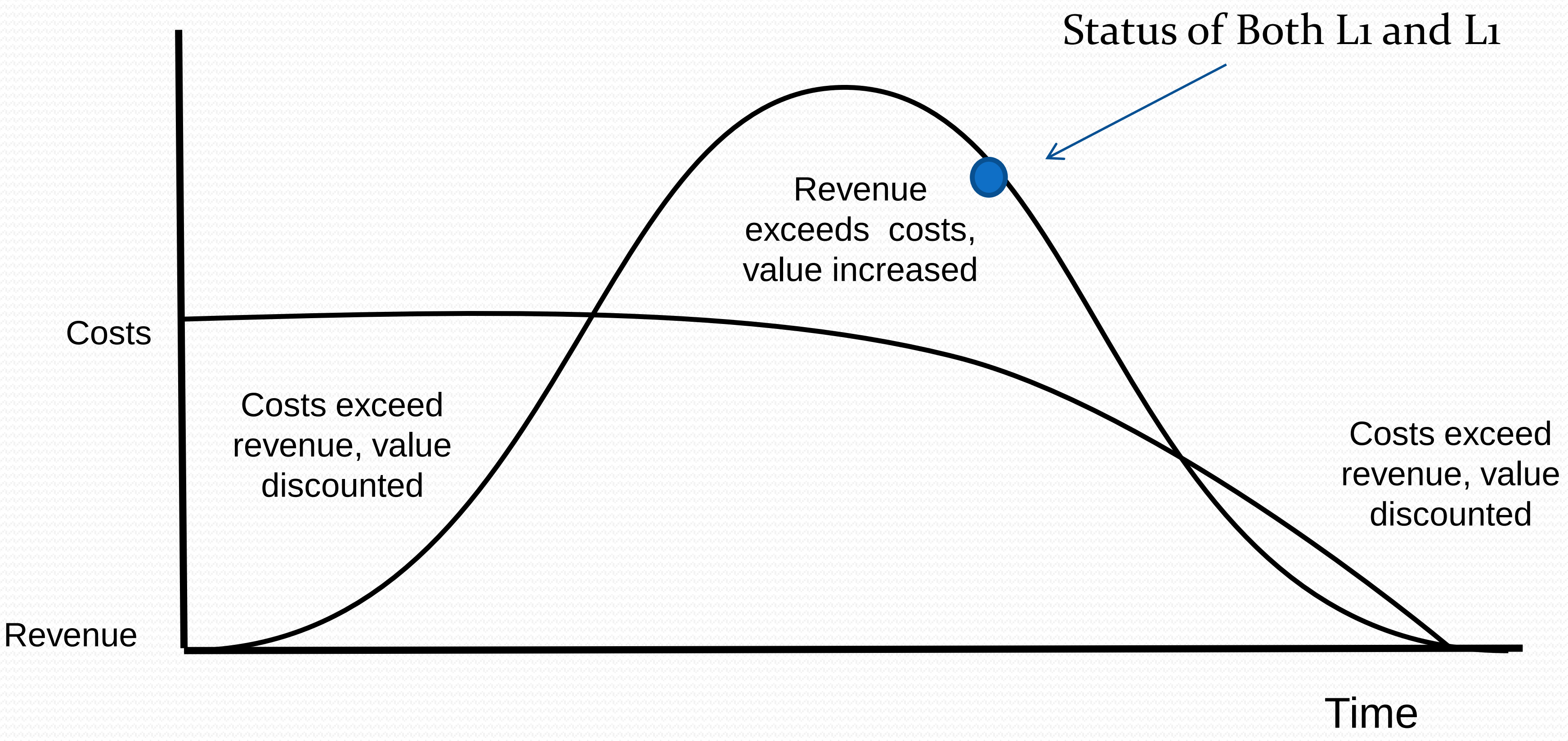

Example 4 – Valuation Methods

- VC's
  - DCF
- Target Company – T
  - DCF

Summary

- Software valuation depends on perspective
- Software valuation depends on circumstances
- Intangibles play a significant role in software value
- Leave it to the experts – amateurs usually loose

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