'Revenue is Vanity, Profit is Sanity': Why illustrating a path to profitability will be key for Software & IT Services businesses in 2024

The post-pandemic macroeconomic environment of higher inflation, rising interest rates, geopolitical tension and softer economic growth has led to depressed valuations across nearly all sectors in the UK, with the exception of SITS businesses.

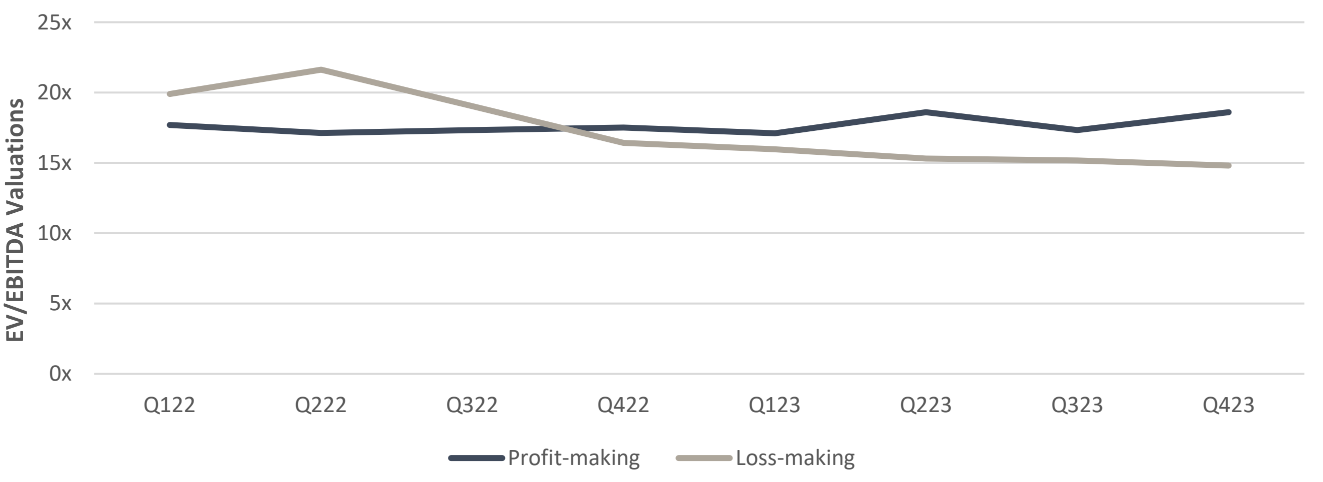
During the pandemic, SITS businesses generally saw fast growth and elevated valuations, as economies shifted to remote working practices whilst social distancing measures were in place. SITS businesses were seen as 'safe havens' for investors during this period driven by several factors: high levels of recurring income, strong gross margins, impressive cash conversion ratios, and asset-light business models. Post-pandemic, with slower levels of economic growth, investors and acquirors sought fast growing SITS businesses. As a result, it became more customary to value SITS businesses based on revenue multiples such as Annual Recurring Revenue (ARR), rather than using profit multiples based on EBITDA.

Despite valuations decreasing since the height of the pandemic, SITS business valuations have remained resilient, with both volumes and valuation multiples greater than their pre-pandemic levels. The benefits of digitalisation has been supplemented by the rise of Artificial Intelligence (AI) software keeping SITS sector valuations buoyant on the promise of driving greater productivity across all sectors. In effect, the SITS sector has become the foundation on which wider industries across the economy have been able to stabilise and boost valuations.

However, in this relatively higher cost of capital economy, funding loss making growth has become more expensive and investors are increasing due diligence on potential investee SITS companies. Preferring a shorter timeframe to profitability has become a focus for investors and acquirors.

With a recent shift in investor preferences, SITS companies are advised to demonstrate a viable 'path to profitability', due to a move to valuing businesses on EBITDA and cashflow as opposed to recurring revenue (ARR). Therefore, loss-making SITS businesses, which have previously prioritised "growth at all costs", have seen valuations significantly decline compared to profitable SITS businesses.

Our research data* shows, that on average, profitable SITS companies saw an 8.7% increase in EV/EBITDA valuations between Q123 and Q423, whilst loss-making SITS businesses saw a 7.2% decrease in EV/EBITDA valuations over the same time period.



*A large public company analysis undertaken by Gambit with loss-making and profitable SITS businesses compared.

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We expect to see the ’Rule of 40’, which characterises strong software companies as those where both annual revenue growth and EBITDA margin added are in excess of 40%, still applicable but less prominent in 2024, with a greater weight on EBITDA margin over revenue growth. SITS businesses will need to take this into account before deciding on their fundraising or sale decisions to realise maximum shareholder value.

Therefore, in 2024, as macroeconomic uncertainty continues, SITS businesses should focus on demonstrating a clear and tangible path to profitability to potential investors to maximise shareholder value.

In this more challenging macroeconomic environment, leveraging the expertise of a knowledgeable corporate finance advisors to support a quality proposal to the most relevant investor audience will be key in achieving an optimal outcome.

Gambit Corporate Finance is a leading independent corporate finance advisory boutique specialising in advising private and public companies on mid-market transactions in the UK and overseas. With offices in London and Cardiff, Gambit is a market leader in M&A advice in the Software & IT Services sector having built up detailed industry knowledge and an enviable track record in deal origination and execution.

If you would like to arrange a call to discuss the current market trends and/or the opportunities available to create, augment or realise shareholder value, please contact a member of the Software & IT Services sector team.

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