cogent valuation

Valuation Focus

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Internet Services Valuation Studies – Part 2: Customer Relationship Management

As the internet continues its rapid expansion, demand for software built to manage customer relationships has increased dramatically. The experienced professionals at Cogent Valuation ("Cogent") possess the expertise to value internet-based customer relationship management ("CRM") companies, constituting firms providing software as a service ("SaaS") platforms that enable business clients to measure their online presence as well as analyze customer traction and feedback. The CRM industry requires substantial research and development costs to build an assortment of software packages that uniquely service the needs of businesses operating in various industries. In our first published article of this three-part series, we discussed the elements that drive the financial metrics and market multiples of companies in the data storage and colocation industry. This second article focuses on the principles of fundamental financial analysis of a private company operating within the CRM industry in the context of providing CRM software related to internet services. We describe the process of applying fundamental financial analysis to determine the value of an internet-based CRM company through the evaluation of company-specific financial metrics, market multiples, and multiples from recent M&A transactions.

Observations on CRM Companies

CRM companies must rely on their development staff's expertise, which facilitates the creation of specialized products and services for other businesses. The most successful CRM companies offer SaaS packages that track content, measure customer interaction, analyze customer feedback, and provide recommendations for implementing future strategies related to customer directed marketing. They pacakge these software capabilities individually or bundled into enterprise-level software to fit client needs. The success of CRM companies derives from their ability to market proprietary SaaS software, negotiate favorable pricing, and maintain license agreements with customers. CRM companies that possess patented SaaS platforms achieve higher profit margins as well as legal protection for their original developments. Management's abilities to control pricing, extend contracts, and receive protective patents impact the value of internet-based CRM companies.

Cogent Method and Analyses

The business analytics industry grew at an estimated 2.0% per year between 2008 and 2013 and is expected to grow at a compounded annual growth rate of 3.9% per year between 2013 and 2018[1]. The industry will continue to grow as internet and cloud computing expand and as new products and services are tested and find acceptance in the market. CRM software provides clients with an internet tool that can track performance metrics and end-users' subsequent activities in sharing the client's media. Successful internet-based CRM companies report basic metrics such as the number of views or impressions of web pages and content as well as provide software that allows clients to track the sharing and distribution of media in order to profile users based on demographics, interests, and online activities. This information is processed by the company's software and is then interpreted to evaluate the effectiveness of online marketing campaigns. This process provides a basis for influencing future marketing decisions, thereby providing value to users of the SaaS package. The clients of internet-based CRM companies purchase software that aids in the process of user-directed marketing.

Therefore, the research and design team primarily drives revenue through thier ability to design software suitable to a particular client's needs, which assists in improving the client's growth or returns. Management, who must be skilled in summarizing the benefits of the software and the value-added reporting and analysis that the software provides, negotiates pricing and renegotiates the terms of contracts.

A valuation specific to this industry requires an analysis of research and development costs as well as the abilities of the underlying workforce, which foster innovative design and encourage favorable contract terms. These conditions contribute to the company's projected growth and return on research and development activities. CRM companies generally have low fixed capital requirements. Instead, it is human capital that is the primary focus of the valuation.

Human capital is evaluated through the consideration of several factors, including: (a) prior work experience and education of employees;
(b) efficiency in developing new

software, which may be measured through the development team's speed and accuracy; (c) ability to negotiate pricing for various levels of software capabilities suited to the client's needs; (d) retention rate of contracted clients measured by customer attrition, known as "churn"; and (e) ability to improve existing software packages to provide clients with enhanced software that evolves with changing business activities.

Business valuations for early stage companies in the customer relationship management industry require market insight into the operations and personnel of comparable companies and analysis of metrics related to contract acquisitions, contract retentions, M&A activities, IPOs, secondary offerings, current market innovations, and SEC filings. Early stage companies are characterized by a charismatic management team with a vision to provide groundbreaking, value-added software to an industry saturated with various SaaS platforms. Therefore, the set of comparable companies must demonstrate similarities in the stage of development, size (measured both in terms of physical size and financial metrics), rates of contract acquisition and retention, cost structure (especially for research and development costs), and, to some degree, capital structure. These principles are relevant in selecting appropriate acquisition targets from recent M&A transactions for purposes of comp- arative analysis and the pricing of securities.

After analyzing the company-specific metrics of the firm as compared to similar companies, Cogent can test the feasibility of the company's projections and expected profitability measures. The financial and market data relevant to the valuation provides Cogent with a basis for utilizing some combination of the following three valuation methodologies to develop indications of value for the subject company and their security interests:

1) Discounted Cash Flow Analysis
2) Comparative Analysis to Publicly Traded Companies
3) Comparative Analysis to Acquisitions of Similar Companies

Unique Considerations

Cogent recognizes several key factors affecting the value of CRM companies that produce SaaS platforms. The primary drivers of value consist of the human talent procured by the management team and management's role in acquiring and strengthening relationships with clients. Prior experience and education of employees fosters intelligent discussion and plays a vital role in designing novel product capabilities and features that can be packaged and sold to business clients. However, management must leverage the intelligence of the development staff to negotiate favorable product and service pricing. Finally, management must have the aptitude to recognize additional product capabilities that can be sold or developed for existing clients and use these evolving products and services as key selling points when renegotiating contracts. If an internet-based CRM company can organize a knowledgeable, innovative staff with concrete direction from a supportive management team, the company can create specialized, value-added products and demand preferential pricing arrangements for those products. The ability to acquire and maintain customer relationships increases company revenues for each dollar expended on research and development, thereby increasing the company's value through improved profit margins. In summary, the defining drivers of value for internet-based CRM companies include the skilled human capital as and the workforce's ability to create software that provides a positive return on investment to the client.

Concluding Remarks

Traditional methodologies are appropriate in performing the valuations of internet-based CRM companies. However, due consideration must be given to the human resources used in the company's operations. The development and management teams play vital roles in creating and selling software to business clients. By measuring the returns on the project costs of research and development activities, Cogent can compare the efficiency of the company's research and development staff to similar companies. Management's abilities to acquire and maintain contracts can also be measured through acquisition and retention rates. Through a comparison of operating margins, acquisition rates, and churn rates, Cogent develops conclusions specific to the company's operating performance, market position, and future opportunities. After collecting and analyzing this information, Cogent selects appropriate market multiples and market-based discount rates to apply to the company's financial metrics in determining the value of the firm and its securities.

1. *Schmidt, Dale. "Business Analytics & Enterprise Software Publishing in the US." IBISWorld.*

About Cogent Valuation

Cogent is a nationally recognized firm that has provided independent valuation and financial advisory opinions in thousands of situations since 1991.

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