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Valuing a Software Company

OVERVIEW

Software companies are often valued at 50%, 100% or more of their annual revenues, depending on the company's expected future revenues and profitability.

While valuing a software company using a multiple of revenues method is easy, it may also be wrong. Software companies should also be valued by calculating the cost to re-create the company's software and also by calculating the present value of the company's future cash flows.

Valuing rapidly growing software companies with low profitability is challenging.

COST TO CREATE

The costs incurred to create a software program may indicate the software's value, if management believes it would take a similar investment to re-create its current software product.

However, management often believes they could more efficiently re-create the software by avoiding programming miscues.

The software company can be valued under both of the "cost to create" methods (the actual costs incurred and the expected costs to be incurred) and the more supportable number of these two should be used.

FUTURE PROFITS (DCF) METHOD

If a software company expects rapid revenue and profitability growth, it also needs to be valued based on its future revenues and cash flows. These future cash flows can be discounted back to their present value to determine the company's value.

The company's projected cash flows need to be supported by the company's historical revenue growth and earnings growth. The market saturation point for the company's software product should be considered when years of rapid growth are predicted.

MANAGEMENT

Valuing a software company is often largely based on a qualitative assessment of whether management has the technical competence, the experience to develop a successful software company, and a clear vision for their software product.

If management has previously built a software company and has consistently met their previous goals, then the company's projections may be more reliable.

ACCESS TO CAPITAL

Successful software companies often make large investments to develop and market their software before sustainable revenues are received. Therefore, it is important sufficient capital is available to keep the company alive while developing the software.

CLIENTS AND POTENTIAL CLIENTS

A software company with many stable and growing clients is more valuable. Also, a software company with good potential for future growth and a history of regularly adding new users is also more valuable.

There is a significant difference between developing packaged software that essentially is sold as-is "off the shelf" and customized software that is personalized to each user's needs. Packaged software requires little customization and may allow the company to more rapidly expand its revenues and profits.

Please call me with your comments at 916.756.5622.

— Thomas Collins, CPA / ABV, CFA

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