

State of Vertical SaaS

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The Vertical SaaS Revolution

Software-as-a-Service is changing. For years, horizontal SaaS companies have achieved massive valuations by building products that addressed generic business needs like CRM or accounting. This meant they could reach the widest possible audience by selling to customers in a wide variety of industries. But SaaS startups are increasingly achieving multi-billion dollar valuations by building software tailored to the needs of specific industries, rather than specific business functions. The recent IPOs of vertical SaaS companies like Blend, Procore, and Toast are proof of the massive upside for companies building industry-specific software.

The reason vertical SaaS markets seem small is because they are typically measured by the size of the existing base of installed software. But this ignores the many opportunities for vertical SaaS companies to expand their addressable markets. They can increase ACVs by raising prices, upselling with new features, integrating or partnering with fintech providers, or embedding commerce solutions. By targeting a specific vertical, they can also capture substantial market share that serves as a launchpad for expanding internationally or into new verticals.

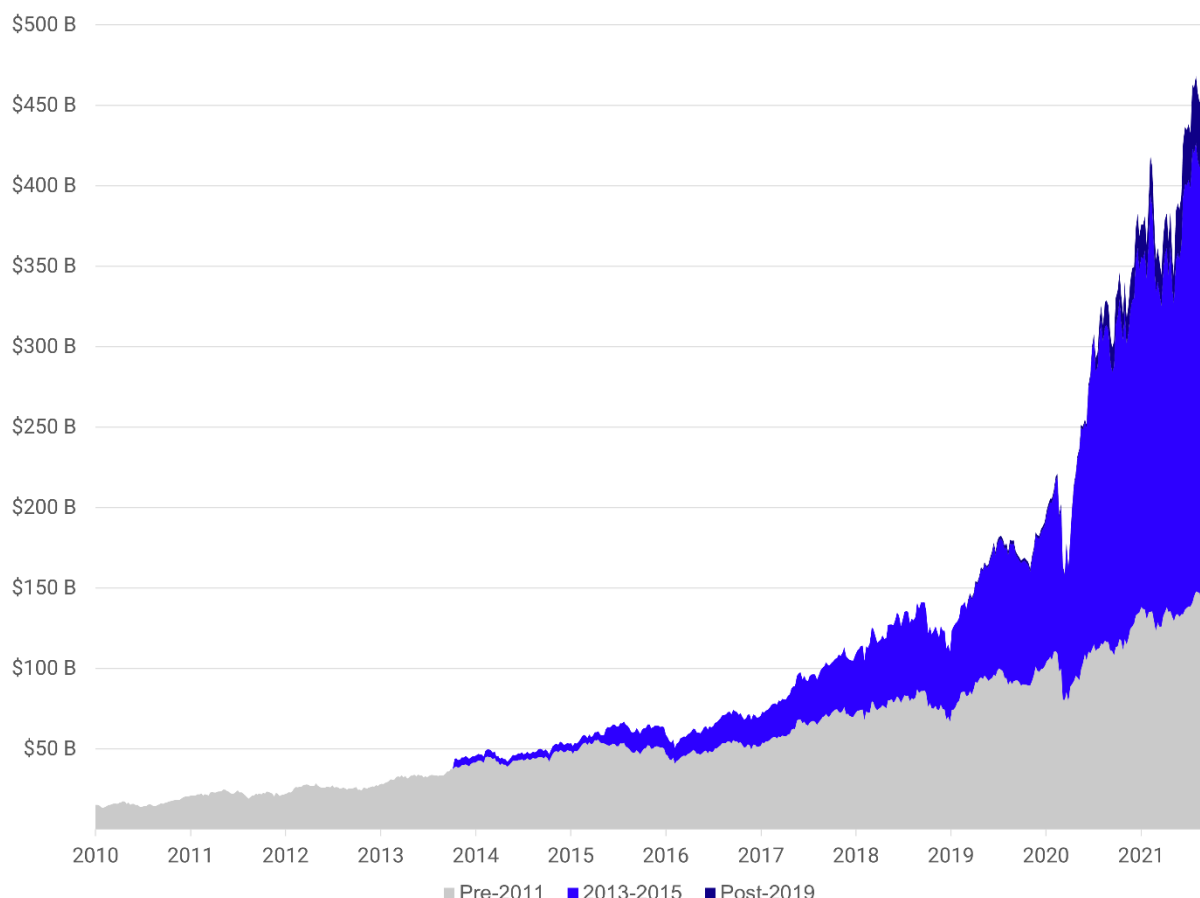
The rapid growth of vertical SaaS in public and private markets reflects a secular trend toward the digitization of all industries. Today, employees and customers expect businesses to use modern software tools regardless of their industry or size. Yet a staggering number of businesses still use outdated on-premise software, DIY solutions, or cobbled together software products. In fact, many businesses have found it easier just to stick with pen and paper instead of dealing with shoddy software.

Even though these businesses may recognize the value of using vertical-specific software for their workflows, there are no high quality software products built for their industry. This points to an inescapable conclusion: vertical SaaS is poised to be the next big thing in cloud software. It's already possible to see evidence of this in the public markets, where vertical SaaS companies have significantly outperformed the major indexes for several years. And this is just the beginning.

A Banner Year for Vertical SaaS in Public Markets

The Fractal Vertical SaaS Index is a basket of 18 public companies that derive most of their revenue from industry workflow software. All but four of the companies in the index IPO'd after 2000 and more than half of the companies in the index have IPO'd since 2014. The index and analysis does not include data from public vertical SaaS companies that were subsequently taken private (e.g., Mindbody).

Vertical SaaS Index Performance Q1 2010 - Q3 2021

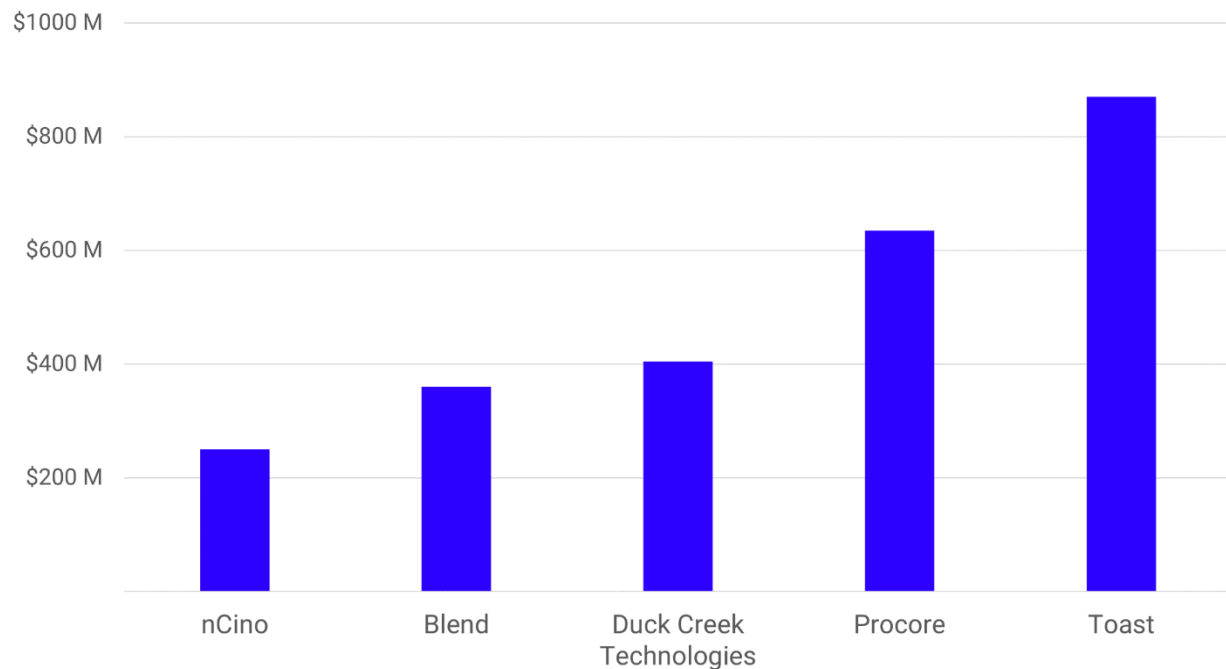


The number of vertical SaaS companies in the index has grown by **28%** since the beginning of 2020 alone. In fact, the first three quarters of 2021 saw the most vertical SaaS companies go public in any year since 2015. The combined market cap of the 13 companies in the index that were public in March 2020 has appreciated by **117.3%**, which significantly outperformed both the S&P 500 (48.8%) and the NASDAQ (78.4%). This demonstrates the remarkable strength of vertical SaaS despite the global pandemic.

Today, the median market cap of the companies in Fractal's vertical SaaS index is **\$11 billion**. The five vertical SaaS companies that began trading publicly since the beginning of the pandemic—Ncino, Duck Creek Technologies, Procore, Blend, and Toast—raised a combined **\$2.5 billion** at their public debut. The total market cap of the Fractal Vertical SaaS index increased from \$178.9 billion in March 2020 to \$441.4 billion at the end of Q3 2021. 76% of the **\$262.5 billion** increase in market cap, \$210 billion was driven by the appreciation of existing companies in the index while the remaining

\$52.5 billion is attributed to the public debut of 5 new vertical SaaS companies and their subsequent growth.

Amount Raised by Vertical SaaS Companies That Have Gone Public Since March 2020



Companies in the Fractal vertical SaaS index have a median **11.5x forward revenue multiple** and more than a third of the companies in the index trade at forward revenue multiples above 15.0x. The median revenue growth of companies in the vertical SaaS index over the next 12 months is expected to be **21%**, which is on par with the median NTM growth rate of all public SaaS companies. The median free cash flow margin over the next 12 months for companies in the vertical SaaS index is expected to be **12%**, which is twice the median FCF margin of all public SaaS companies (6%).

The Procore Bellwether

The highly successful Procore public offering this year was a leading indicator that points to a strong investor demand for vertical SaaS businesses. More fundamentally, the Procore IPO demonstrated the immense amount of value that can be created by building industry-specific workflow software.

Procore is an important bellwether for vertical SaaS because it is a company that defies conventional wisdom about what makes a software business successful. Construction is a \$1 trillion industry, but its software spend represents less than a hundredth of the industry revenue. It is also one of the most analog sectors imaginable. According to McKinsey's industry digitization index, construction is

the second least digitized industry across all major sectors. To sell a SaaS product into the construction industry wasn't simply a matter of getting contractors to change their software provider; it meant fundamentally changing the way the industry conducted its business.

Procore pulled it off despite these headwinds. Its S-1 revealed that it is targeting an annual market opportunity of \$9.4 billion based on current estimates of software spend within the construction industry and the company's available products. At present, Procore's annual revenue is around \$400 million, which means the company has significant room for growth. While that's below the median for a public SaaS company, Procore is growing at a fast clip (38% over the past year) and has maintained high gross margins (82%).

Importantly, Procore noted that the estimates of industry spend on software likely underrepresents the company's true addressable market, which its S-1 filing described as "significantly underpenetrated." This is because current software spend estimates don't account for Procore's ability to digitize processes not served by existing industry software or the company's ability to sell products to other stakeholders involved in the same construction projects, thus multiplying the company's revenue on the same dollar of construction spend. "Based on our experience with customers, we believe we address a greater opportunity not yet quantified by this estimate," Procore wrote in its S-1 filing. Indeed, this is a key reason why so many investors have overlooked massive opportunities for vertical SaaS in most sectors in the past.

Procore's more SaaS-specific metrics look great, too. According to the S-1, the company has just over 10,100 customers with an average contract value of \$43,000. Its product is also very sticky. Procore reports a gross retention rate between 94 and 95% over the past three years. Its net retention rate also speaks to the lucrative upsell opportunities available to the company: Over the past three years, Procore has an average net retention of 115%. Despite the company's relatively steep 29-month gross margin adjusted CAC payback period, the high net retention rates and average ACV mean that Procore can still have a strong LTV/CAC ratio.

Most vertical SaaS companies will not face the same obstacles that Procore faced when selling its software to construction businesses. Today businesses in most industries rely on some kind of software for their daily operations. It might be as simple as an Excel spreadsheet or they may use a vertical solution built by an industry insider. In short, small-and-medium businesses are now receptive to the idea that modern software can help them run their companies more effectively.

Procore's landmark IPO was the headline event for vertical SaaS over the past year, but it wasn't the only industry software company to make a splash in public markets. Blend, a SaaS platform for financial services firms, went public in June raising \$360 million with a market cap of nearly \$4 billion. Blend is an important vertical SaaS case study because it shows the power of expanding a

company's addressable market by targeting adjacent verticals. Blend began as a software solution built around mortgage applications and now offers a diverse range of products ranging from consumer insurance marketplaces to personal loan and credit card applications.

Blend's public debut was followed by the restaurant software provider Toast, which filed for an IPO in September after months of delays. Founded in 2012, Toast has been a darling of the vertical SaaS industry due to its rapid growth and strong market penetration. At its public offering, Toast raised \$870 million at a valuation that topped \$20 billion, but only a few months prior its success was far from certain and shows the potency of leveraging fintech integrations to expand the addressable market for workflow software.

During the early days of the pandemic, Toast was forced to cut half of its workforce due to restaurant sales falling by more than 80% in many cities. Its platform was primarily built to combine restaurant point-of-sale systems with back office workflows like inventory management. But in response to shifting dining dynamics driven by global pandemic, Toast rapidly adjusted its software platform to meet the evolving needs of restaurants. It prioritized features that made online and contactless ordering simpler. Toast had prioritized fintech integrations early on, which enabled the company to rapidly increase revenue by taking a cut of online orders after reconfiguring its product to meet the needs of restaurants battered by Covid. The results are striking: In the second quarter of this year, Toast nearly tripled its revenue over the same period last year to \$424.7 million.

The successful public debuts of Procore, Blend, and Toast herald the arrival of the vertical SaaS decade. They have drawn attention to a segment of the software industry that has been overlooked by investors for years, while also proving many of Fractal's core theses around vertical SaaS. The core lesson from Procore, Blend, and Toast is that a vertical SaaS company's market is often far larger than it initially appears. By digitizing previously analog workflows, expanding into adjacent verticals, and integrating fintech applications onto an industry-specific workflow platform, vertical SaaS companies can expand their addressable markets by orders of magnitude compared to estimates based on current industry software spend.

Vertical SaaS in Private Markets

The recent swell of vertical SaaS IPOs has understandably generated a lot of buzz about industry software companies in the private markets as well. The past year has seen several notable financial and strategic vertical SaaS acquisitions as well as an influx of venture capital into early and late stage vertical SaaS startups.

One of the most notable events in the M&A space was ServiceTitan's acquisition of Aspire, a startup building software for commercial landscapers. Aspire was a strategic acquisition for ServiceTitan,

an 8-year-old company that started building software for residential plumbing, HVAC, and electrical contractors before expanding into other field service businesses. It was the company's second major acquisition this year after they acquired ServicePro, a pest control software company, in February.

ServiceTitan's acquisition of Aspire underscores the importance of specialization when building software for highly fragmented industries with complex workflows such as commercial landscaping and pest control. In these verticals, it is more strategic for incumbents to acquire startups that have developed expertise in the area and have a foothold in the market instead of building competitive products from scratch.

Elsewhere in M&A, this past year saw Squarespace acquire Tock for \$400 million to accelerate its entry into the restaurant industry and shortly after the private equity firm Thoma Bravo acquired the property management software provider RealPage for \$10.2 billion.

These mega-mergers highlight the appetite for vertical SaaS companies along four primary vectors: private equity or financial acquisitions; strategic acquisitions by vertical SaaS unicorns; strategic acquisitions by horizontal SaaS companies; and strategic acquisitions by non-software companies in the same vertical. This is good news for vertical SaaS founders and their investors, who have several M&A options to realize a meaningful exit as an alternative to an IPO.

Investors are taking note and breeding vertical SaaS unicorns. On the heels of its Aspire acquisition, ServiceTitan announced a \$200 million Series G round at a \$9.5 billion valuation. The funding came just three months after the company raised \$500 million at an \$8.3 billion valuation in a round led by Sequoia's Global Equities Fund and Tiger Global Management. KeepTrucking, a software provider for trucking companies, joined ServiceTitan in the ranks of unicorn vertical SaaS companies this year with a \$190 million Series E round that valued the company at \$2 billion.

A substantial amount of VC dollars flowed into early- and mid-stage vertical SaaS companies this year, too. Qualia, a real estate software provider founded by Fractal co-founder Nate Baker, raised a \$65 million Series D that officially tipped the company into unicorn territory. Squire, a software platform for barbershops, raised a \$60 million Series D at a \$750 million valuation just months after closing a \$59 million Series C. On the earlier side of the fundraising spectrum, Cents, a laundromat SaaS provider, hauled in a remarkable \$9.3 million during its seed round.

The combination of a white-hot private market, the unprecedented speed of deal flow, and growing investor interest in vertical SaaS suggests that the investment into industry software at massive valuations is a trend that is likely to continue at least into next year.

Meet the Vertical SaaS Unicorns



Industry: Hospitals
Founded: 2012
Valuation: \$4B



Industry: Trucking
Founded: 2013
Valuation: \$2B



Industry: Hospitals
Founded: 2016
Valuation: \$3.2B



Industry: Real Estate
Founded: 2012
Valuation: \$1.5B



Industry: Real Estate
Founded: 2015
Valuation: \$1B



Industry: Biology Labs
Founded: 2012
Valuation: \$4B



Industry: Construction
Founded: 2015
Valuation: \$3B



Industry: Automotive Dealers
Founded: 2016
Valuation: \$3.5B



Industry: Field Services
Founded: 2013
Valuation: \$9.5B



Industry: Interior Design
Founded: 2009
Valuation: \$4B



Industry: Physicians
Founded: 2014
Valuation: \$2.1B



Industry: Social Services
Founded: 2013
Valuation: \$1.6B



Industry: Cannabis
Founded: 2017
Valuation: \$1.7B



Industry: Real Estate
Founded: 2010
Valuation: \$1B



Industry: Spas
Founded: 2010
Valuation: \$1.5B



Industry: Heavy Industry
Founded: 2014
Valuation: \$2.3B



Industry: Shippers
Founded: 2014
Valuation: \$1.2B



Industry: Financial Advisors
Founded: 2016
Valuation: \$1B



Industry: Restaurants
Founded: 2014
Valuation: \$2.9B

Industry: Shipping
Founded: 2015
Valuation: \$2.75B

What's Next for Vertical SaaS

1. Increased frequency of strategic and financial acquisitions of vertical SaaS companies

High margins and product stickiness make vertical SaaS companies desirable acquisition targets for private equity firms, as demonstrated by Thoma Bravo's recent acquisition of RealPage. But it's not just PE that's interested in vertical SaaS companies. They also become attractive strategic acquisitions for horizontal and growth-stage vertical SaaS companies once they've captured substantial market share in their industry. As the new generation of vertical SaaS startups hit their stride, we expect to see a wave of M&A scooping up these companies.

2. More vertical SaaS companies overall

Given the massive opportunity in vertical SaaS, there will be noticeably more entrepreneurs organically founding industry-specific software companies in the coming years.

3. New vertical SaaS companies entering smaller markets

The success of companies like Slice, a vertical SaaS provider for pizza shops that raised a \$43 million series C in 2020 and Cent, which recently raised a \$9 million seed round to build software for laundromats, demonstrates the growing awareness that it is possible to achieve venture-scale outcomes in ostensibly small markets. New vertical SaaS startups will pursue opportunities with relatively small first order TAMs and use these entry points as a wedge to expand their addressable markets.

4. Influx of vertical SaaS companies to public markets

There was a notable lull in vertical software IPOs following the offerings for Mindbody, Black Knight, and Appfolio in 2015. But the IPO momentum for vertical SaaS companies started picking up again in 2020. This past year saw the monster IPOs of Procore, Blend, and Toast, which will mark the beginning of a new era of vertical SaaS unicorns going public.

5. More venture capital flowing to early stage vertical SaaS companies

"Vertical SaaS" seems to be on every investor's lips these days. They're talking about it at [Andreessen Horowitz](#), [Redpoint Ventures](#), [Bowery Capital](#), and [Bessemer Venture Partners](#), which recently predicted that the "vertical SaaS wave will become a tsunami." We expect to see substantially more VC momentum around early and growth stage vertical SaaS startups.

6. **Accelerated growth rounds for vertical SaaS companies**

ServiceTitan's one-two punch in fundraising this year netted the company \$700 million in capital within 6 months and Squire tripled its valuation to \$750 million across two funding rounds in 6 months. This clearly demonstrates the power of blitzscaling in vertical markets. Vertical SaaS is by its nature a winner-take-most business model driven by the relative ease of capturing market share in a specific industry. There will be substantially larger mid-and-late stage growth rounds for vertical SaaS companies to fuel the hypergrowth that leads to market dominance.

About Fractal Software

Fractal Software launches and finances vertical SaaS companies that solve real problems for businesses in overlooked industries. We unlock entrepreneurship for exceptional individuals by providing capital, a co-founder, a business idea, and ongoing support as their company grows. Together, we'll create fast-growing vertical SaaS companies that modernize the way America's small and medium businesses operate so they can better serve their communities.

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