OCTOBER 2022 FRACTALSOFTWARE.COM

State of Vertical SaaS

22

INDEX

fractal

Vertical SaaS in Public Markets: Taking the Long View

What a difference a year can make.

When we published the first edition of the State of Vertical SaaS last October, markets were still a month away from their peak, interest rates were low, venture investors were deploying record amounts of capital at sky high valuations, supply chain challenges seemed to be easing, and there was no land war in Europe.

Fast forward 12 months, though, and the financial markets have become more complex and full of unknowns. At the time of writing, all three major stock indices have tipped into bear market territory, interest rates have hit multi-decade highs, and there is an increasing risk of a global recession. VC deal flow has dropped from its pandemic highs and investment firms are sitting on record amounts of dry powder. These are worrying signs to be sure, but it's not all bad news. While VCs are taking a more sober approach to their investment strategy, the amount of capital being deployed into private tech companies is still fairly high in a historical context. The same is true for publicly traded SaaS companies, whose average multiples have retreated to the historical average, even though the best-in-class companies are still fetching valuation multiples as high as 30x.

Although it may seem like optimism about the future of tech is rare, we've never been more bullish on the future of vertical SaaS. In fact, we believe that right now is the best time in the past decade to build vertical SaaS companies. This is not just due to the inherent strengths of the vertical SaaS business model, but also because both public and private vertical SaaS companies are still showing amazing strength.

The gloominess about the collapse of tech valuations—and SaaS valuations in particular—makes sense if you only look at the performance over the past 12 months. But when you zoom out, you'll find that the vertical SaaS industry is still demonstrating incredible strength. Fractal's index of vertical SaaS companies in public markets is above its pre-pandemic highs and in private markets investors continue to mint vertical SaaS unicorns. This reflects a broader trend in the digitization of every industry, which shows no signs of slowing. US corporate spend on cloud services is expected to grow 56% through 2024, and vertical SaaS companies will be a major beneficiary of this secular trend. As for the drawdown in public SaaS companies, when you take the long view, it's evident that this is just a reversion to the mean. As we'll see below, the wild exuberance for tech investments between 2020 and 2021 had pumped public and private SaaS valuations to unsustainable levels. A correction was inevitable and—ultimately—a healthy development for the industry.

Nevertheless, the top quartile of private enterprise software companies are still valued at multiples in excess of 30x, reflecting the enduring strength of this category. As Silicon Valley Bank noted in a recent report, companies in the "operations software" subsector, which includes vertical SaaS, continue to have among the highest multiples in the tech industry.

Why Take the Long View?

We believe taking the long view of vertical SaaS is justified for several reasons. First, it allows for the comparison of its performance across multiple timescales. We can look at the performance of vertical SaaS companies prior to the pandemic and ask whether they appeared to be struggling or were valued at unsustainable levels. In retrospect, they were neither. The decade leading up to the COVID-19 pandemic, vertical SaaS showed solid growth at reasonable multiples. Even after the massive drawdown from last year's highs, the Vertical SaaS Index is still above its pre-pandemic levels. Since January 2020, the total market cap of the Vertical SaaS Index has grown by **18%** and the total LTM revenue of the companies in the index has doubled from **$14.9B to $29.5B**. Roughly 11% of that revenue growth can be attributed to companies already in the index prior to 2020 with the remainder accounted for by the addition of six new companies to the index in the interim. Of the 12 companies that existed in the Vertical SaaS Index in January 2020, only 5 have seen a decline in market capitalization as of October 2022. Of the companies whose market cap increased during this time period, the median increase in market cap was 33%. This gives us immense confidence in the resilience of vertical SaaS as an industry and continued growth in the years ahead.

Second, the long view reveals that the growth of vertical SaaS is not a fad. Unlike SPACs, NFTs, and other well-known pandemic investment fads, the growth of vertical SaaS over the past decade represents a long-term trend rather than a pandemic-driven aberration. While vertical SaaS companies may have gotten swept along in the irrational exuberance that characterized markets over the preceding two years, their long range trend line is up and to the right. This makes perfect sense if you believe, as we do, that vertical SaaS heralds one of the biggest revolutions in productivity in the modern age. We're still in the early innings of this transformation and in the long run, the market weakness over the past year will be a blip on the radar in the rise of vertical SaaS.

Finally, we believe that taking the long view is crucial for anyone founding a vertical SaaS company—or any tech company, for that matter. At Fractal, we're in the business of helping exceptional individuals build their own vertical SaaS businesses, which is inherently a multi-year project. The reality is that founders who are building vertical SaaS companies today will exit into market conditions several years from now that will, in all likelihood, look entirely different. It's for this reason that the legendary investor Bill Gurley has declared that right now is likely the best time to build a software company in the past decade. We strongly agree. The market conditions 3, 5, or 10 years from now are out of a founder's control. But what they can control is building a great software company on a proven model in an environment that rewards adherence to business fundamentals. In this respect, vertical SaaS is one of the best business models in the game because it is absolutely essential to the customer's workflow, which yields high LTV and high margins.

For vertical SaaS users, the software isn't discretionary and the strong relationship between the customer and vendor provides vertical SaaS founders with a solid foundation to weather turbulent market conditions.

Does this mean that vertical SaaS founders will be impervious to pain if we see a global recession in the coming 12 months? It does not. Weak markets are painful for everyone and vertical SaaS companies are no exception. The difference, however, is that vertical SaaS companies are uniquely well-positioned to not only survive but thrive in tough conditions. Vertical SaaS is an essential service that will be the last cost to be cut during hard times because it powers the core workflows of its users. This is why Robert Smith, the founder and CEO of Vista Equity Partners, has characterized software contracts as "better than first-lien debt." Businesses will forego payments on debt before missing a software subscription payment because they can't run their company without the software. This inherent strength of vertical SaaS, combined with the strong secular tailwind of the digitization of every industry, should give vertical SaaS founders and investors peace of mind as they navigate the turbulent macro environment. With the benefit of a long-term perspective, it's clear that we are in the early stages of a software revolution that shows no signs of slowing and the vertical SaaS companies being built today are positioned to be the biggest winners of the paradigm shift in the way American businesses work.

The Vertical SaaS Index

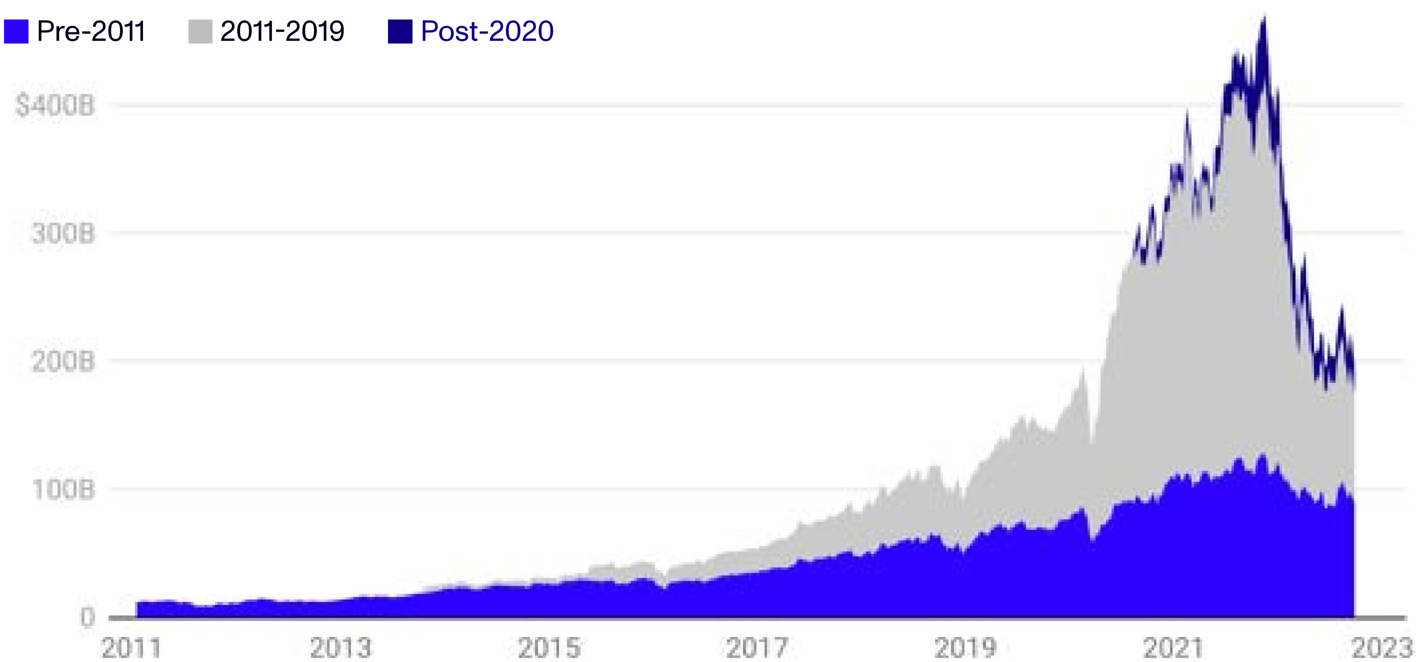
The Fractal Vertical SaaS Index is a basket of 19 public companies that derive most of their revenue from industry workflow software. All but four of the companies in the index IPO'd after 2000 and more than half of the companies in the index have IPO'd since 2014. The index and analysis does not include data from public vertical SaaS companies that were subsequently taken private (e.g., Mindbody). All data is sourced via PitchBook and current as of September 30, 2022.

Since the last State of Vertical SaaS report was published in October 2021, only a single company has been added to the Fractal Vertical SaaS Index.

On December 7, 2021, Vacasa, a software platform for vacation rental management, went public via a Special Purpose Acquisition Company at a valuation of roughly $4B. The downturn in IPO activity over the past 12 months is not unique to vertical SaaS companies. According to Dealogic, approximately 87% of companies that went public in the US in 2021 are trading below their offering prices and are down more than 49% on average. This weak performance has caused many companies to postpone their planned IPOs, including ServiceTitan, the field services software provider, which had reportedly filed for an IPO in January at an $18B valuation—nearly twice the valuation of its most recent round in 2021 at $9.5B.

Vertical SaaS Index Performance 2011-2022

Performance of vertical SaaS companies sorted by year of public listing.



Toast's Fintech Bonanza

In the rapidly growing pantheon of vertical SaaS success stories, few companies loom larger than Toast, which provides an "operating system" for the restaurant industry. In September 2021, just a decade after Toast's founders launched the company as a short-lived, consumer-facing restaurant app before pivoting to a point-of-sale solution, Toast went public at a valuation well above $30B. Like most public SaaS companies, Toast has experienced a painful drawdown in its market cap over the past year, but at the time of this writing, it is still valued at a healthy $9B, a clear indication of investors' belief in its long-term prospects. During the height of the pandemic, it would have been easy to attribute Toast's runaway success to changing dynamics of the restaurant industry, which suddenly needed new technological solutions to serve customers in extreme circumstances. But Toast's enduring success, even in the face of turbulent market conditions, suggests that something deeper is at play and it may reveal the secrets to success for vertical SaaS founders and investors alike.

The reason Toast can justify its $9B valuation is because it is a multiproduct platform. It was able to become a multiproduct platform because it controlled strategic positions in its customers' workflows. But finding and dominating this control point is neither obvious nor straightforward. For Toast—and any other vertical SaaS company that aims to replicate its success—it is critical to deeply understand its customers' workflows in order to identify unmet customer needs and key control points in the flow of information through a business.

We can see how challenging identifying and entering these control points are by looking back at Toast's origins. In 2011, its founders—Steve Fredette, Aman Narang and Jonathan Grimm—had set out to make an app that would allow restaurant customers to open a tab and pay on their phone. This was certainly a real paint point for customers, but hardly the basis for a multi-billion dollar business. The three founders discovered this the hard way when no VCs wanted to invest in a company that was, indirectly, taking on the massive incumbents that provided restaurant point-of-sale systems1. If the company that would become Toast wanted to generate returns worthy of VC investment, it would have to compete with these legacy providers head-on. And that's exactly what it did.

Toast's decision to switch its core product from a point solution that helped solve a particular problem for restaurants (i.e., collecting customer payments) to a comprehensive back-of-house management system was key to its success. Toast's founders clearly recognized that the ability to handle payments was a crucial feature for any restaurant software system, but by becoming a complete system of record for restaurants rather than just a payments solution, it could control the payments channel and several others, too.

[1] https://www.cnbc.com/2021/09/25/toast-built-a-30-billion-business-by-defying-silicon-valley-vcs.html

The impact of Toast's pivot to a system of record is easily seen in its growth into a multiproduct platform over the past decade. In addition to its back-of-house management system, Toast also offers its customers a point-of-sale solution for payments, payroll services, and loans through Toast Capital. While entering the restaurant industry as a payments point solution wouldn't necessarily have precluded Toast from offering these same products, it would have been much more challenging if Toast wasn't already established as a system of record. For example, consider loans offered to restaurants through Toast Capital. These loans are underwritten by the financial data stored in the core workflow software and automatically serviced by taking a small percentage of each sale through the POS system. If Toast didn't control the data flowing through the core system of record, it would have been much more expensive and risky to underwrite loans to its customers.

The importance of the multiple fintech products enabled by Toast's system of record was highlighted in the S-1 released ahead of its IPO. In this document, Toast revealed that the revenue from its "financial technology solutions," which include its payment, payroll, and lending products, dwarfed the SaaS subscription revenue from its core workflow software.

In the six months leading up to Toast's IPO, the revenue from financial services was more than nine times higher than its SaaS subscription revenue.

This trend has continued to this day. In Toast's most recent quarterly filing, its revenue from financial services in the preceding six months had nearly doubled YoY from $581M in the six months leading up to June 30, 2021 to $1B in the six months leading up to June 30, 2022. In fact, the revenue from Toast's fintech solutions accounts for approximately 82% of its total revenue. While fintech was always a part of Toast's DNA, they were only able to achieve such incredible success in verticalized fintech services by becoming a core system of record for their industry first. Seen this way, the real value of developing a core system of record for the restaurant industry was not so much in the subscription revenue, but the revenue expansion opportunities it would enable—particularly in financial services. Dominating this control point in the customer's workflow was the key to becoming a multiproduct platform and a multi-billion-dollar vertical SaaS company.

Investors have only just begun to understand the importance of embedded fintech for expanding TAM in vertical markets, and Toast's enduring success underscores the truth of this hypothesis. But embedded fintech is hardly the only pathway to a multiproduct vertical SaaS platform. Shopify's massively expanded feature-set, for example, ranges from ad buying tools to NFT-driven "tokengated" commerce. What unites these seemingly disparate trends is that the best vertical SaaS businesses are key control points in the workflows of their customers, which gives them privileged access to other areas of customer spend. Because vertical SaaS products inherently power day-to-day workflow operations it simplifies the process of adding new functionalities on top of those core workflows and eases the distribution of new products. This gives vertical SaaS companies a unique ability to capture larger portions of their customer's software spend while deploying fewer resources than a competitor that does not occupy a key control point.

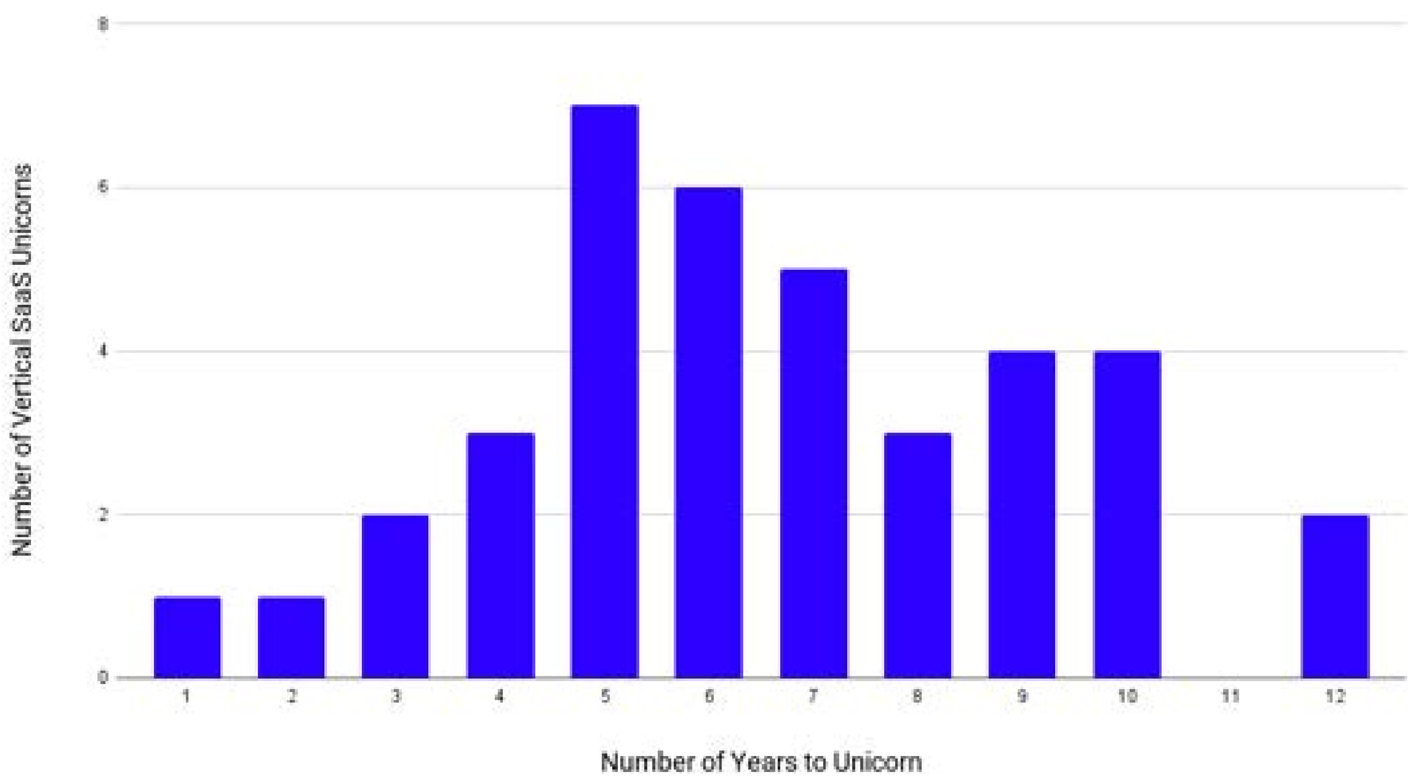
Although it is frequently said that vertical SaaS is "inherently" a multiproduct software play, this isn't necessarily true. As Toast's experience demonstrates, it is critical for vertical SaaS companies to identify key control points in their customers' workflow and start there, rather than working toward building a system of record by starting with a narrow point solution. While this is not an impossible strategy, our experience suggests that it is far more challenging to start with a point solution and then build a system of record than the other way around. What is true is that vertical SaaS has unique advantages over its horizontal peers on the pathway toward becoming a multiproduct platform. The multi-billion dollar valuations of Toast, Shopify, Procore, and other multiproduct vertical solutions suggest that following this strategy will be the key to achieving venture-scale outcomes in the years to come.

Vertical SaaS in Private Markets

In the past 12 months, vertical SaaS companies in private markets have still seen a substantial amount of activity in terms of both M&A and valuations. Since the last State of Vertical SaaS was published in October 2021, investors have minted 11 new vertical SaaS unicorns. This represents a 40% increase in the number of vertical SaaS unicorns and brings the total number of vertical SaaS unicorns to 38.

While this growth is impressive, in relative terms, the number of vertical SaaS unicorns minted in the past 12 months is down 39% compared to the previous 12 months, which saw 18 new vertical SaaS unicorns join the pack. The combined valuation of all vertical SaaS unicorns is $97.4B and ServiceTitan accounts for almost 10% of this given its most recent valuation of $9.5B. The median valuation of vertical SaaS unicorns is $2B.

Distribution of vertical SaaS companies by the number of years to unicorn



This chart depicts how long it took the 38 vertical SaaS unicorns to achieve valuations of at least $1B.

M&A Activity

In addition to a herd of new unicorns, the past year has witnessed a tremendous amount of M&A activity in the vertical SaaS space. While M&A is an extremely common exit mode for many vertical SaaS startups and we can't possibly cover all the acquisitions in the past year, there were a handful of deals that really grabbed our attention, including:

Constellation Software's Acquisition Spree
Constellation Software has the notable distinction of recognizing the opportunity in vertical SaaS years—if not decades—before everyone else. Founded in 1995, from the start, Constellation has focused on acquiring vertical SaaS companies and optimizing them for cash flow while allowing their acquisitions a high-degree of independence. As the owner of more than 150 vertical SaaS companies, it's no secret that Constellation is constantly on the hunt for strong industry-specific software businesses. Still, Constellation's rate of acquisition in the first part of this year was enough to turn heads. Between March and early August, Constellation acquired 57 vertical SaaS businesses in industries as diverse as K-12 lunch programs, jail management, and physiotherapy. That pace is equivalent to roughly one acquisition every other business day, a strong sign that while the public markets may be weak, the vertical SaaS thesis remains as strong as ever.

Oracle Buys Cerner, Its Largest Acquisition Ever
In late December, the enterprise software giant Oracle completed its acquisition of the electronic health record provider Cerner for $28.3B. The acquisition is Oracle's largest to date by a substantial margin—based on reported acquisition prices, it is nearly 3 times larger than its next largest acquisition of PeopleSoft for $10.3B in 2005. Oracle justified the massive acquisition price on the basis that it would be a major growth engine for the company that would be accretive for the company's earnings. The acquisition followed on the heels of the $17B acquisition of Athenahealth last year by two private equity firms and highlighted Oracle's determination to have a larger presence in the healthcare space, which Oracle CEO Safra Catz described as the "largest and most important vertical market in the world." The scale of the Cerner acquisition is a portent of the future where large enterprise software companies begin to acquire vertical SaaS companies at an increasing rate and growing valuations in orderto enter new markets where verticalized incumbents already have a strong foothold.

ABC Fitness Acquires Glofox, Launching a Private Equity War in Fitness Software

In August, the fitness software provider ABC Fitness Solutions acquired Glofox, one of the leading providers of fitness software for boutique gyms, for an undisclosed amount. It was the latest in a series of strategic acquisitions for ABC, which has included Trainerize, GymSales, and FitnessBI just in the past two years. The acquisition represents a significant consolidation in the fitness software industry by turning ABC into one of the largest technology providers in the space. Even more interesting is what is happening behind the scenes. ABC is a Thoma Bravo portfolio company that until the Glofox acquisition largely played in the "open gym" space. Coming from the opposite side of the spectrum is Mindbody, whose dominance of the boutique fitness area led to it being taken private by Vista Equity in 2019. In other words, the two largest fitness technology vendors are both private equity-backed, but until recently, were competing in different segments of the fitness vertical. Now, with the acquisition of a boutique fitness software provider, ABC has taken a major step onto Mindbody's turf. The writing is on the wall and it seems probable that Mindbody will return the favor by moving more aggressively into the open gym market with some strategic acquisitions of its own.

OpenGov Acquires Cartegraph, Highlighting Govtech Growth

Until recently, government-focused software has been a laggard in the vertical SaaS industry. Challenging sales cycles and a general reluctance to adopt new tech solutions made government SaaS a remarkably challenging market to operate in. But OpenGov's July acquisition of Cartegraph, a SaaS provider for public agency operations and infrastructure asset management, appears to indicate that we are on the cusp of a bright new era for government SaaS. For more than a decade, OpenGov has built cloud software for a variety of government functions such as budgeting, permitting, licensing, and code enforcement. Over the past few years, however, OpenGov has stepped up its pace of acquisitions, which have included ProcureNow and Clear Rec. This is a strong signal that there is a rapidly growing appetite for modern SaaS solutions in the public sector and that this market may be ready for a wave of verticalized software solutions.

Meet the New Vertical SaaS Unicorns

ALLOY

Industry: Banking
Year Founded: 2015
Valuation: $2B

Athelas

Industry: Medical Practice
Year Founded: 2016
Valuation: $2B

built

Industry: Construction
Year Founded: 2014
Valuation: $2B

Clarify

Industry: Medical Practice
Year Founded: 2015
Valuation: $1B

DRAGOS

Industry: Industrial
Year Founded: 2016
Valuation: $1.7B

loadsmart

Industry: Logistics
Year Founded: 2014
Valuation: $1B

MARK43

Industry: Public Safety
Year Founded: 2012
Valuation: $1B

place.

Industry: Real Estate
Year Founded: 2018
Valuation: $1B

tebra

Industry: Medical Practice
Year Founded: 2012
Valuation: $1B

vagaro

Industry: Spas
Year Founded: 2009
Valuation: $1B

What's Next for Vertical SaaS?

Every year, we ask Fractal's research team for their predictions about major trends over the next few years in vertical SaaS. Here's what they see on the horizon:

Larger ACVs for New Vertical SaaS Companies Compared to Incumbents

The idea behind this prediction is simple: the solutions offered by new vertical SaaS entrants are far superior to the solutions of legacy incumbents. At Fractal, we've already seen the ACVs for our portfolio companies dramatically surpass our preliminary estimates, indicating a deep demand for better software across a broad range of industries. Bigger picture, this means the TAM for many verticals is significantly bigger than it looks on the surface and the vertical SaaS opportunity is even more attractive than expected. (Ben Marans, Associate)

More Low-Code/No-Code Vertical SaaS Tooling

The primary benefits of low-code/no-code tools are reducing deployment time for applications by taking a "drag-and-drop" approach to software development and offering high levels of customization that traditional third-party SaaS applications cannot match. While low-code/no-code tools have made significant inroads into many areas of software (particularly web development), vertical-specific products in this category are relatively scarce. This is starting to change with the advent of tools such as PatternBuilder (legal SaaS document creation). We can expect to see significantly more low-code/no-code tools with a vertical focus in the coming years, especially in multi-vertical sectors like healthcare and legal services.
(JP Gschwind, Principal)

More Tech-enabled Services Layered into Workflow SaaS Products

Vertical SaaS companies have a number of TAM expansion techniques at their disposal that range from embedded fintech products to adjacent customer bases and more. In the future, we can expect more vertical SaaS companies to layer tech-enabled services onto their core SaaS offering to provide additional value to the customer and to expand their TAM. Revenue cycle management (RCM) is already a common example of this model in healthcare SaaS. Many practice management / electronic medical record (EMR) SaaS vendors offer RCM services on top of their core SaaS product and in some cases RCM contributes more to their ACV than the SaaS revenue. This allows practice management / EMR vendors to own an even larger share of their customer's external vendor spend than a SaaS-only model and helps them solve an additional customer pain point, which makes their relationship with the customer more durable. However, this strategy comes with downsides: tech-enabled services generally represent lower margin, less predictable revenue than the traditional SaaS business model. (JP Gschwind, Principal)

AI Tools Like GPT-3 Will Transform Vertical SaaS
Over the past 12 months, we've witnessed the incredible power of large language models like OpenAI's GPT-3, which can produce various kinds of text (e.g., articles or code) based on simple prompts. While this technology is by no means perfect—especially when it comes to writing functional code—it's clear that as it improves, it will disrupt many industries, including vertical SaaS. One possible outcome is that it will turn vertical SaaS into headless databases of structured data that people can query with increasingly complex requests in natural language. For example, imaginea contractor using a vertical SaaS platform running GPT-3 will be able to verbally issue a command like "When our foremen hit their 1 year anniversary, send them an email." The AI is not only able to figure out what a foreman and 1 year anniversary is based on the data, but also the text to put into the email. This future could be here sooner than we think. (Martin Kess, Head of Engineering)

More Verticalized Middleware
Over the past year, we've witnessed a remarkable growth in verticalized middleware, or software that acts as the connective tissue between applications and/or data. The rise of verticalized middleware speaks to the proliferation of a variety of different software solutions, horizontal and vertical, in the tech stack of a typical business. Vertical middleware helps specific industries effectively manage these solutions from a common platform. As more and more applications are built that cater to specific industries, there is the risk that vertical SaaS experiences the same "app overload" horizontal SaaS users experience by having to juggle multiple applications throughout their workflow process. Middleware is an effective solution to this problem and also a lucrative niche for vertical SaaS companies. Expect to see a lot more of it in the not-too-distant future.
(Gabriella Monico, Senior Associate)

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.

Learn more at www.fractalsoftware.com