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Are SaaS Businesses the New Safeties?

The performance of our Software-as-a-Service (SaaS) holdings in a challenging COVID-19 environment has led us to question whether these companies may offer the benefits of more typical recession-resistant businesses, but with potentially more sustainable growth. Here is what we think you need to know.

Key Highlights

- The traditional software business model has significantly evolved toward a SaaS model, which, for some companies, has resulted in stronger business economics and resiliency.
- A transition to the SaaS model can potentially unlock significant value for a business by addressing the shortcomings of the traditional software model, reducing costs, establishing a recurring revenue stream, and providing more pricing power.
- Pursuing a SaaS model is a complex process and demands significant upfront investment, but if successful, can result in higher margins and more consistent revenues.
- A dominant competitive position and customer need are essential to unlocking value. And when investing, this unlocked value should be considered against current valuations.
- In an accelerated digital-first environment, we believe software companies have become even more mission critical to their customers both professionally and personally.

The typical growth company may conjure images of a fast-growing, highly valued tech-focused operation. But growth businesses can come in all shapes, sizes, and industries. At Polen Capital, we invest across the growth spectrum; we have always believed that a select number of slower growing but steady businesses provide compelling growth investments. We refer to these types of companies as our "Safeties" because of the potential we see for consistent and predictable annual double-digit earnings growth.

With these "Safeties," we aim to provide ballast to our portfolios and, perhaps more importantly, stability and principal protection during difficult market environments (illustrated in our Growth Spectrum chart in Figure 1). The mix of both steadier and faster growth businesses, we think, differentiates us from other investment managers and has contributed to our long track record of protecting capital in declining markets. We think this downside protection also enables us to compound growth off a higher capital base. As an example, in 2008, some of the top relative performers in our Focus Growth portfolio, which outperformed its primary benchmark by approximately 1000bps that year, were our "Safety" companies, including Abbott Labs, C.R. Bard, ADP, Genentech, Staples, and St. Jude Medical[1].

Historically speaking, we've often found these types of "Safety" investments in the classic recession-resistant sectors such as consumer staples and healthcare. However, more recently, software subscription businesses appear to be taking on the same characteristics but with arguably more sustainable growth.

1 As of December 31, 2008.

Investing Across the Growth Spectrum

Safety	Growth
Low teens double-digit EPS growth	20%+ EPS growth
Slower but steadier growth	Faster growth
Typically lower valuations	Typically higher valuations

Figure 1: Source: Polen Capital.

Over recent years, several companies, particularly in the software industry, have shifted their business models away from transaction-based revenue streams towards more recurring, subscription-based revenues. We have seen this shift typically result in companies having significantly improved business economics and increased resiliency in the face of recently challenging macroeconomic conditions. With a higher level of recurring revenues combined with the reality that software solutions have generally become mission critical for enterprises competing in a digital economy, these software businesses may offer the best of both worlds: the earnings growth typical of a faster-growing tech company along with the earnings stability and consistency typical of our traditional "Safeties."

Software's Powerful Shift to Subscription-Based Models

Over the past twenty years, one of the more profound business model shifts we have seen is the evolution of the SaaS cloud-based model, pioneered by companies such as Salesforce.com. Traditionally, before internet ubiquity, software companies used a license/maintenance model. A customer would pay an upfront license fee to acquire the software, which could then be installed onto the customer's computer system(s), followed by annual maintenance fees if the customer wanted regular servicing and/or upgrades. While the maintenance contracts provided a stable recurring revenue stream for the software providers, revenues could still be lumpy. In tough times, businesses could delay upgrades or suspend maintenance services but continue to use the software. Additionally, because the software needed to be installed on the customer's IT system (remember Microsoft Office floppy disks?), they were subject to piracy.

The SaaS model, now seemingly omnipresent across the software industry, addresses the previous model's shortcomings by allowing customers to access the software through an internet portal.

Thus, software no longer needs to be installed on a customer's IT system, reducing piracy risk. It also potentially reduces internal IT maintenance costs because the responsibility falls to the software provider. Upgrades occur automatically whenever a new version of the software is available, thereby preventing the customer from delaying the upgrade. Furthermore, because the customer accesses the software online, they can only use it if they have an active subscription. In other words, customers can no longer work around upgrading or paying maintenance fees and use an older version of the software.

This subscription, internet-based model also allows for easier price tiering. Basic software packages can be offered for lower monthly prices, which, in turn, can make the software more affordable for smaller businesses. Case in point, in 1999, when Microsoft rolled out Microsoft Office 2000, the cheapest version for new customers was $499. Today, a basic online subscription of Office 365 starts at $5/month. This subscription model also makes it easier to pass along price increases each year. Because these software solutions are often mission critical to the customer, price increases seem to be swiftly accepted by many customers. Finally, accessing the software through the provider's portal gives better data on how the customer uses it and what features can be added or improved. The result can be higher retention rates, consistent pricing power, a better user experience, and more predictable revenue growth—in other words, stronger, more stable business models. Precisely what we would expect from our "Safety" investments.

SaaS-Models May Offer Better Economics and Provide Ballast

Arguably, no current holding in our strategies exemplifies the power of this subscription transition better than Adobe. One of the first large cap companies to shift its traditional software business, Adobe turned its dominant digital media franchise into a SaaS-based model starting in 2011. As shown in Figures 2 and 3, as Adobe progressed through this shift and subscription revenues became a larger percentage of total revenues, returns on invested capital (ROIC) initially declined and selling, general and administrative (SG&A) expenses increased as a percentage of revenues. Then, ROIC quickly rebounded, SG&A/sales declined, and both metrics are now at improved levels compared to prior peaks, which indicates to us that the business is stronger than before.

Why this odd profitability dynamic? When a software company transitions its business to a SaaS model, our research shows that revenues and earnings often decline initially. Generally, the company loses the traditional upfront licensing payment and replaces it with a lower monthly subscription fee. And expenses are often higher in the near term because a true shift to a SaaS platform requires investment in technology, salespeople, billing services, etc. In industry parlance, this is sometimes referred to as "Swallowing the Fish" because of the fish-shaped effect a subscription transition can have on a company's profit metrics, as shown in Figure 3. But, as the majority of users are transitioned, revenues and earnings typically recover and margins can potentially exceed prior levels. The recurring nature of the new subscription revenue stream not only has more potential for pricing power, as it is easier to institute modest price increases on a regular basis, but it also requires less selling and servicing expense.

Typically, the company spends less money finding new customers and shipping them software, which now can be easily accessed through the cloud. They also often spend less money convincing current customers to upgrade because usually upgrades happen automatically anytime a new version is available.

Crucially, and we cannot overstate the importance of this point, we believe a SaaS transition works best when a company sells software that its customers consider essential to their business and where other good options are not readily available.

Switching to a SaaS model can be disruptive to an enterprise. Users may need to get familiar with a new software interaction. Even minor issues such as having to open an internet portal and login to an app, rather than just clicking on a desktop icon, can be friction points for users. A SaaS shift can also increase long-term costs for the customer, creating opportunities for a competitor to swoop in and convince the customer to switch to a different software product. But, in our view, for customers of Adobe, a mission critical solution which we estimate has ~90% market share in digital media software and is generally considered the industry gold standard, few compelling alternatives exist. Thus, Adobe's SaaS transition has been successful as customers appear to have willingly adopted its subscription model.

Adobe: Subscription Revenues/Total Revenues

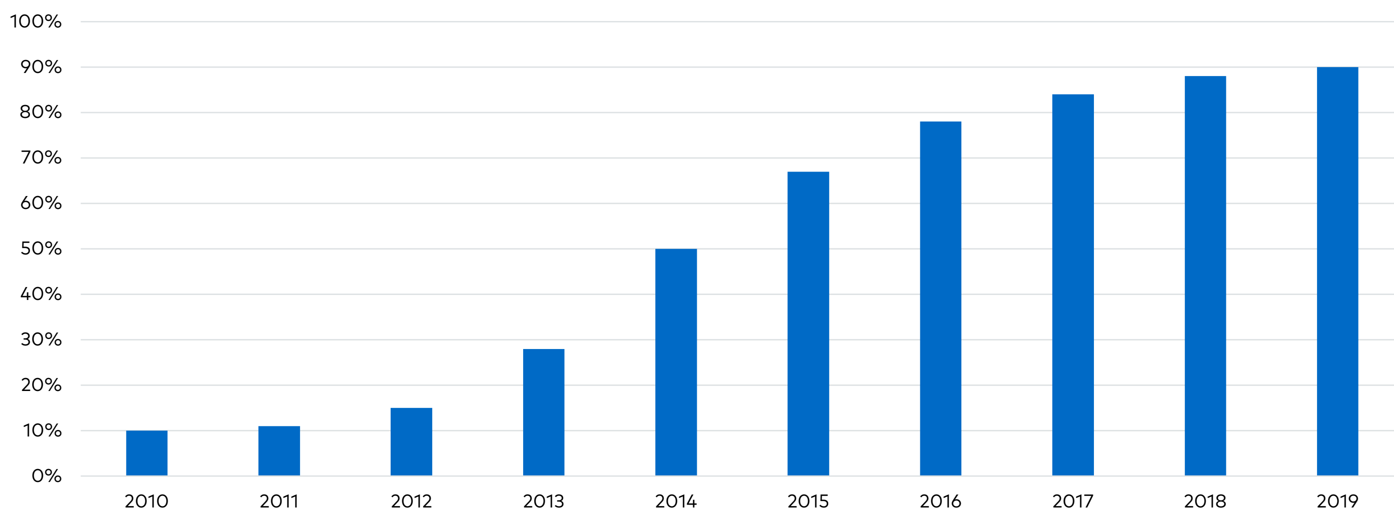

Figure 2: Source: Company Filings.

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Adobe: ROIC vs. SG&A/Sales

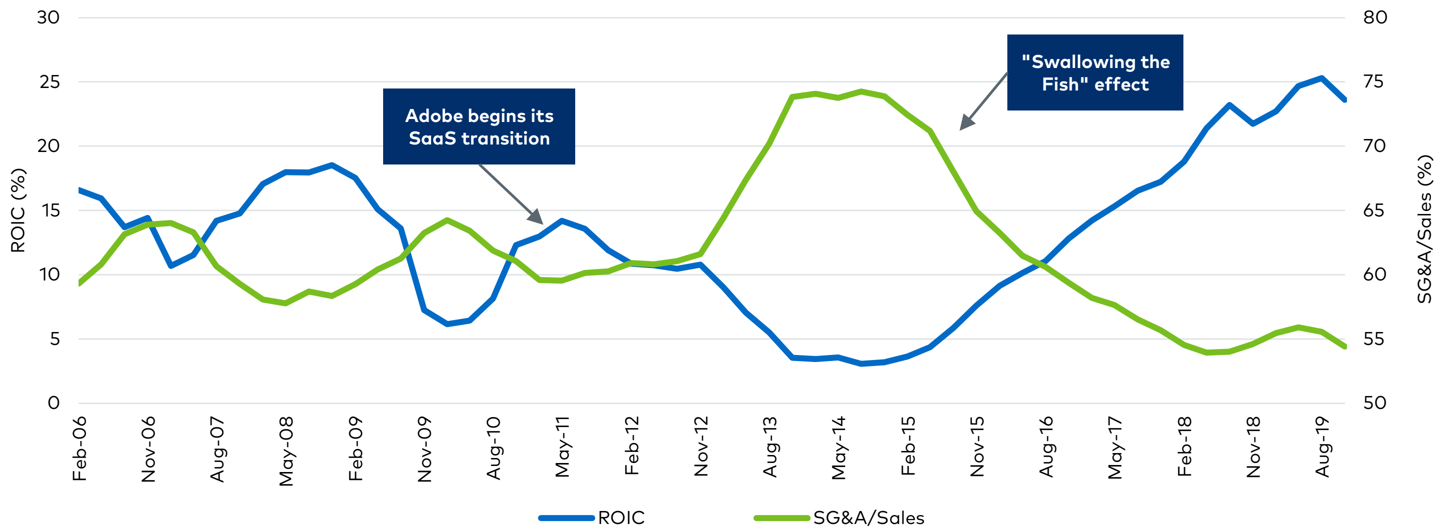

Figure 3: Source: FactSet.

Adobe's subscription revenues approached nearly 80% of total revenues by 2016 as seen in Figure 2, while Figure 4 illustrates that sales growth was strong (20+%) and relatively more stable than prior to this period. Compare this to the recessionary period in 2008-2009, where trailing twelve-month sales growth declined nearly 20% by the end of 2009, even though Adobe's software was as mission critical to clients then as it is today. We believe the primary difference between now and then is the subscription structure of its business model. In the 2008-2009 recession period, it would have been possible for Adobe clients to temporarily delay paying for upgrades or maintenance services to reduce their expenses while still using their existing software license. Today, Adobe no longer provides this option. As a result, in 2020's weak economic environment, we have seen resilience in Adobe's revenue growth despite some deceleration. In this regard, we believe Adobe's financial stability is reminiscent of some of our "Safety" businesses.

Adobe: TTM Sales Growth

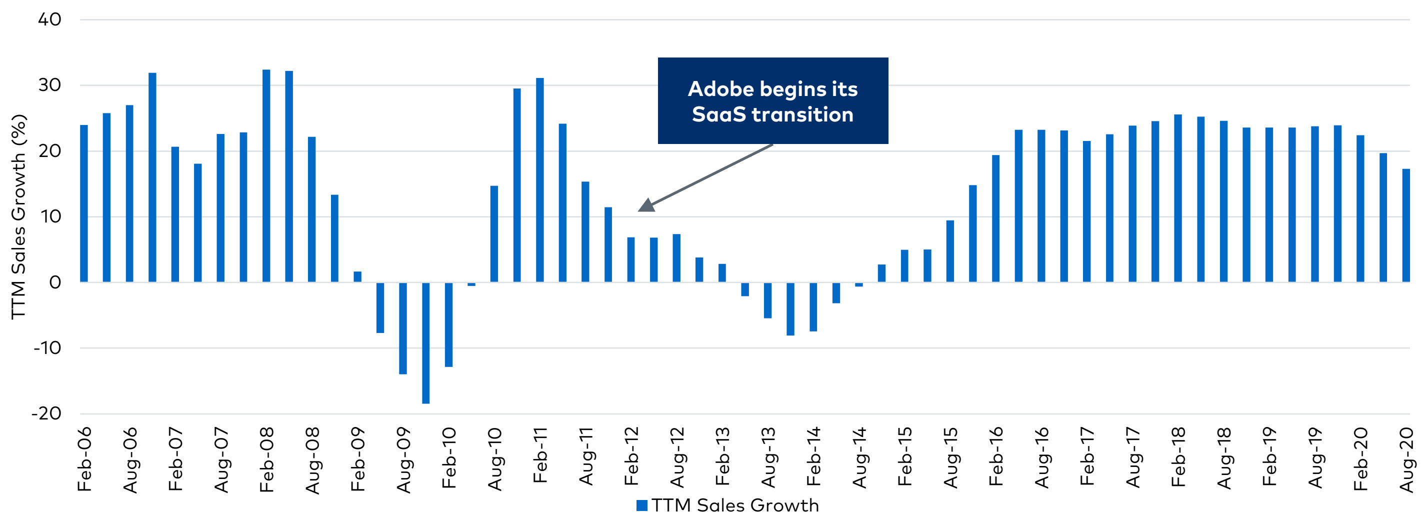

Figure 4: Source: FactSet.

Autodesk's SaaS Transition

Another example is Autodesk, the leader in software solutions for the construction and engineering industry, which transitioned to a SaaS model a few years later than Adobe. Considered by many as the industry standard, various users begin training on Autodesk software early in their careers and even at the university level. As a result, Autodesk software may become sticky. Users are often unwilling to switch to another software solution because of the ubiquity of its use and the new training that would be required. These high switching costs make Autodesk's software another prime candidate for conversion to a SaaS model, a shift the company has been pursuing in earnest since 2016.

As shown in Figure 5, the transition to a SaaS-based model has propelled Autodesk's recurring revenue to a higher percentage of total sales over the past three years, now comprising 95% of total as of FY20. We believe this higher level of recurring revenue has the potential to make Autodesk's revenue growth less cyclical than in the past.

Note in Figure 6, the impact of the 2008-2009 U.S. recession on Autodesk's revenue growth is readily apparent as this period was characterized by significant dislocations in the construction and real estate industries. During this time, our research indicates that Autodesk's license growth was approximately -40%, driven primarily by existing customers delaying upgrades and new license purchases and choosing to use their older software license until economic conditions improved. But as we previously noted with Adobe, Autodesk's new subscription-based model no longer allows customers to postpone upgrades and continue to use their existing software license. Although we still believe that Autodesk's business will be affected by its cyclical end-markets, we would expect that its revenue growth will be less volatile than in the past. At the same time, we believe strong secular tailwinds for Autodesk, namely the trend towards digitization of the construction and engineering industry, should be a catalyst for the company to compound revenue growth at a double-digit rate.

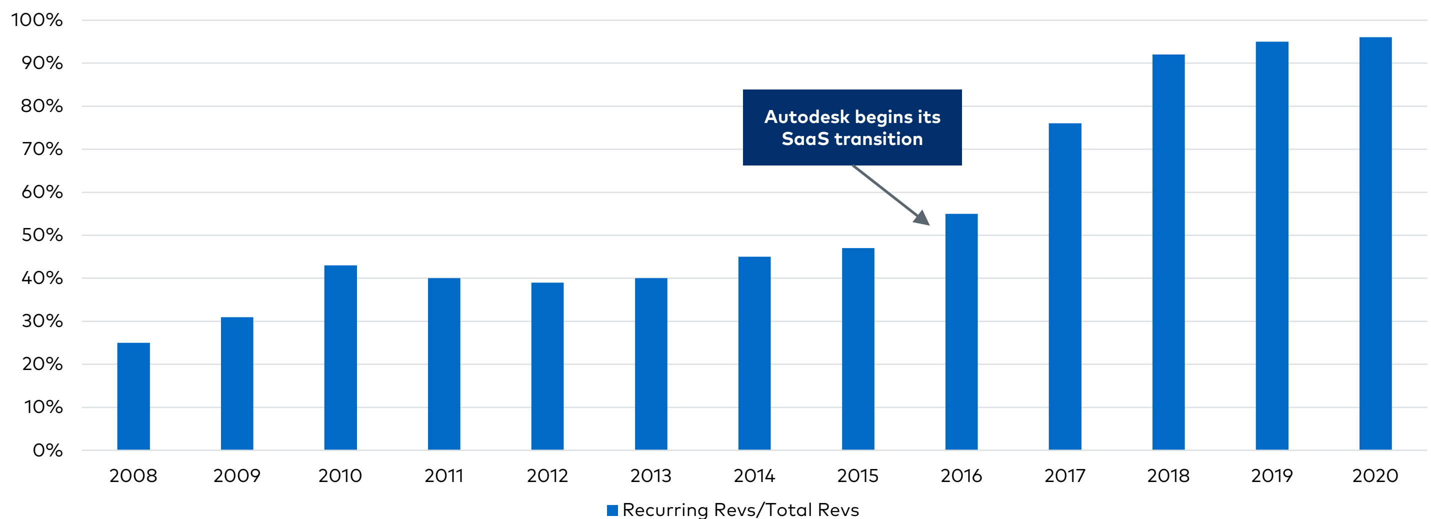

Figure 5: Each year as of Autodesk's fiscal year ending January 31. Source: Company Filings.

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Autodesk: TTM Sales Growth

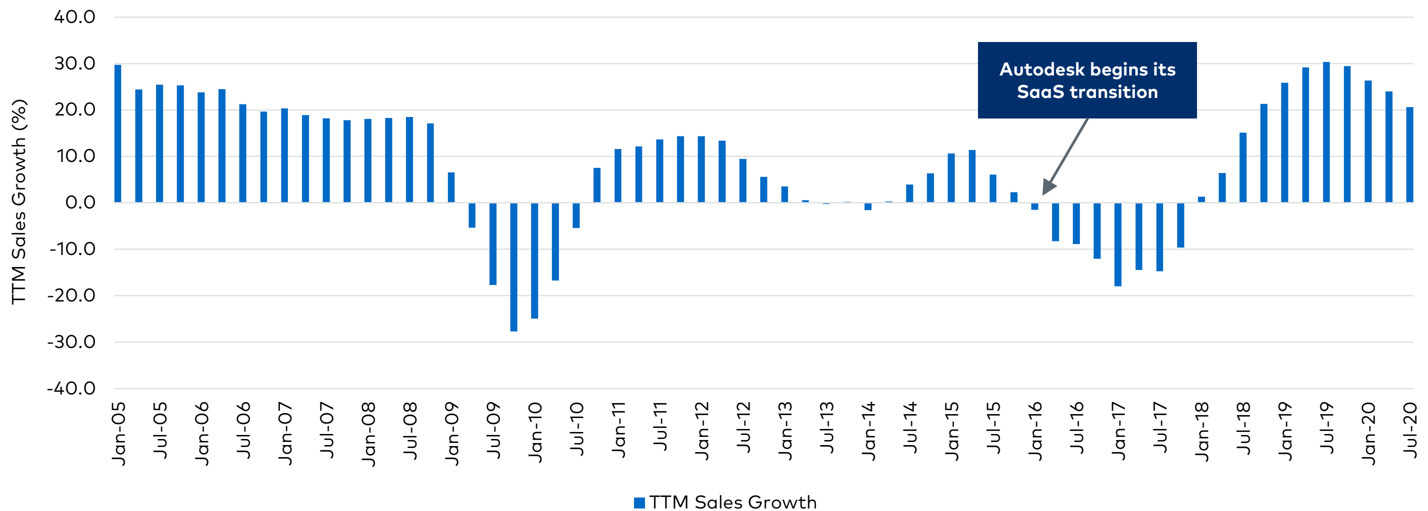

Figure 6: Source: FactSet.

Consider the Unlocked Value Against Valuation

As noted in these examples, not all SaaS transitions are created equal. Various factors can affect the success of a company's migration from a licensed model to a subscription one, including the complexity of the software itself, the disruption it creates for clients, and the costs of switching to a competing product. Across our investment strategies, we have seen several SaaS transitions. In addition to Adobe and Autodesk, other portfolio companies such as Microsoft, Oracle, SAP, Sage Group and Aspen Technology are either finished with or in the process of shifting their software platforms. All have encountered varying levels of difficulty in doing so.

For those companies that have transitioned successfully, our research indicates that the businesses become stronger and more "Safety-like" as a result.

We also need to remember that our traditional "Safety" companies, in addition to generally having stable, but lower earnings growth profiles compared to our more growth-oriented investments, typically trade at more favorable valuations. This is an important variable because while the more stable growth profile of our "Safety" companies contributes to less potential earnings risk, the typical lower valuation contributes to less price risk. Essentially, the transition to a SaaS model and its potential positive impacts on a business still need to be weighed against that business's valuation. From a portfolio management perspective, we continuously strive to find the appropriate balance between these two factors.

The Acceleration of SaaS as Mission Critical

The secular shift towards digital has been in place for many years, and we believe the COVID-19 environment has only served to accelerate this trend. As more people depend on digital technology in their personal and professional lives, software companies further seek to entrench themselves as indispensable and invaluable providers of tools and solutions that their customers need. This digital acceleration has occurred at a time when many mission-critical software providers are transitioning to high recurring revenue, subscription-based business models. In our opinion, the potential result is business models that may prove to be more economically resilient than in the past and yet still offer attractive growth rates. The accelerated shift to "all things digital," the consistency of many of these business models, and the resiliency we have seen during such a unique period lead us to ponder, "Are SaaS companies the new 'Safeties'?"

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Mr. Atkins joined Polen Capital in 2012. Prior to joining Polen Capital, Mr. Atkins spent 12 years as a portfolio manager at Northern Trust Investments, including eight years as a mutual fund co-manager. Before joining Northern Trust, Mr. Atkins spent two years as a portfolio manager at Carl Domino Associates, LP. Mr. Atkins received his B.S. in Business Administration from Georgetown University and a General Course degree from the London School of Economics. Mr. Atkins is a CFA® charterholder and a member of the CFA Institute and the CFA Society of South Florida.

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The Russell 1000® Growth Index is an unmanaged index that measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 1000® Index companies with higher price-to-book ratios and higher forecasted growth values.