GLOBAL MARKETS FORUM

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Q&A- VC funds to tighten capital in 2021, enterprise tech future is consolidation: Collin Gutman, SaaS Ventures

U.S. startups could find it difficult to access venture capital in 2021 as funds grow more selective with their investments, **Collin Gutman, co-founder and managing partner of SaaS Ventures**, told the Reuters Global Markets Forum on Tuesday, September 1.

“The trend we're already seeing will continue - larger rounds, but fewer of them, into category winners rather than pretenders,” he said.

Gutman, whose firm invests specifically in enterprise technology startups, added that consolidation will be the “name of the game” for the sector, with many of his investments likely to become $500 million to $1.5 billion acquisition targets, as larger vendors look to become "one-stop shops” for tech services.

Following are edited excerpts from the conversation:

Q: Could you walk us through the thesis behind your fund?

A: Sure! SaaS Ventures is a bit of a different fund. We invest in only enterprise technology, but we do it in a novel way. We invest in second tier and third tier American cities - we have invested in 23 states so far! And we do so by partnering with local lead investors in each of these markets. So, by partnering with the lead investors we see investment opportunities from all across the country and co-invest with the leads.

Q: What changes have you seen to the enterprise tech landscape because of the pandemic?

A: I think we've seen a real comeback of second tier cities. Places like St. Louis which may have been seen as a less relevant place for tech growth is all of a sudden hot. There's a talent flight out of major cities as density/crowding becomes an issue and remote work becomes possible - so you're now finding even greater quantities of talented techies all across the country.

Q: Interesting - is that something new, or an acceleration of a trend that was already taking shape?

A: It was definitely underway previously. It was a core pillar of our fund when it began in 2017 - that the cost of living and remote work combined with SaaS technology and cloud infrastructure would democratize tech. But the pandemic probably accelerated it 5 years in the span of 3 months.

Q: How do you see the start-ups in this sector poised to come out of the burgeoning economic recovery?

A: Typically, some of the best companies in history are formed during a recession. They learn to be cash-efficient. If you look at 08-09, giants like Facebook emerged from there. I think many startups that have been struggling have been propped up by capital being easy to obtain. Many of those will die off over the coming two years. But the ones that survive are going to truly thrive and emerge on the other side with less competition for capital.

Q: Has your criterion for evaluating potential investments changed as a result of the pandemic, then?

A: I don't think the criteria has changed - we still look for businesses with strong teams and growth markets, for example. What has changed is the capital needs and growth plans. Our companies are raising money with plans to last longer - 18 months rather than 12 in most cases - so that they can survive if things don't go perfectly. We anticipate that bridge funding will be more difficult to raise in '21, so companies need to get sufficient capital today to last the "winter."

Q: So startups could be in for a tough time next year?

A: Absolutely. Funds still have capital that they've raised and have to deploy. But I think funds will be more selective with that capital. March and April of this year saw venture markets slow dramatically. So, I believe the trend we're already seeing will continue. Larger rounds, but fewer of them, into category winners rather than pretenders.

Q: On that, VC deals spiked in the last few months - is that merely the impact of investors holding on to capital during March and April?

A: Absolutely. We have an index of second market deals that we publish monthly on our website. March and April were historically slow. June and July were historically over paced. I think our index showed that July was around 180% of our 12 month rolling average. So pent up demand was released.

I think we believe we're now on pace to have an "average" Q4, which is traditionally slow, as VCs love taking 6 week holiday vacations!

Q: What advantages do you see SaaS companies offering to early stage investors like yourself as opposed to other tech segments?

A: Early stage venture, according to the data we've seen, is the best performing asset class, averaging 44% IRR over the last 25 years as an asset class. It's also tax advantages as it's Qualified Small Business Stock. Within those advantages, enterprise SaaS is phenomenal for two reasons.

One, enterprise tech tends to be more predictable and less binary than consumer tech. Two, when it reaches scale, a SaaS business (think Zoom or Salesforce) runs with phenomenal gross margins and retention rates, making a dollar of revenue equal a much larger profit number than businesses in any other sector.

Q: You've invested in a number of cyber security companies, what views on the development of this sector, especially with all the concerns around security as more people work from home?

A: Cybersecurity was already a massive growth sector before Covid. If you look at the number of data breaches/hacks at big companies - it's on the mind of every single C Suite. From what we've seen, prior to Covid, cybersecurity budgets within enterprises were nearly unlimited. Any product that could reduce vulnerability was purchased.

As devices, connection points and points of failure have increased due to Covid, we've seen the demand for cybersecurity escalate. We're especially interested in securing IoT and mobile devices, as almost all Cybersecurity products to date focus on personal computers, servers or networks.

Q: How are industrial companies utilizing enterprise tech, and how has the pandemic impacted those trends?

A: Manufacturing is actually one of our other sectors of focus. If any of you have been in a factory in the last 5 years, it looks almost the same as it did 30 years ago. There are some legacy enterprise resource planning (ERP) type systems run by someone like an SAP or Oracle, and lots of pen and paper supplemented with people walking around looking at machinery and product. As knowledge leaves the company through retirements, or as Covid forces lower worker density, these processes become deeply imperilled. So, we've seen a race to modernization in the manufacturing industry.

Everything from order intake and marketing to new kinds of automated machinery to new ERP plugins to machine maintenance applications are all quickly becoming essentials to run a factory. Factories are realizing that humans are a fundamental risk to business, and that technology can be the next wave of productivity gains not seen since the Industrial Revolution.

Q: Has there been a change in SaaS selling packages to corporates due to Covid? Do they prefer to buy shorter duration packages due to being cash strapped or something to the effect?

A: There was certainly an impact for two months - as most of our companies reported severe discounting in March and April. As of now, (who can predict the future), life seems back to normal. If anything, businesses seem inclined to sign longer contracts in exchanged for discounted year 1 pricing (give me a discount this year, then you can raise my year 2 and 3 cost).

So, I'd say that businesses still recognize how much they need software, but are trying hardest to soften the 2020 profit and loss impact. We've yet to see businesses express long term budgetary concern ... yet.

Q: On a similar note, do you see setbacks to company efforts to continue with digital transformation drives, given how the pandemic has hit revenue?

A: I only see it accelerating honestly. Digital transformation allows companies to reduce costs and open up new revenue channels. These are the post-pandemic (and current) imperatives. Going back to manual, human intensive or capital-intensive processes is not an option. Digital transformation is the only way for Main Street businesses to access online revenue channels or manual-processing businesses to cut costs.

Q: Thanks Collin. With more companies looking for end to end providers, how does that impact the growth horizon for enterprise startups? Are the best opportunities to exit via larger acquisitions?

A: Consolidation is going to be the name of the game, for sure, for years to come. If you look at what happened with marketing tech, 2010-2014 was a time of a proliferation of vendors. The number of vendors of marketing tech software grew by 10x+. Then there was consolidation onto platforms like Hubspot, Marketo and Eloqua.

I believe the same will happen, especially with cybersecurity. The large vendors will become highly acquisitive in a quest to become the "one stop shop" and will be successful. I think many of our current companies, therefore, will become $500 million - $1.5 billion acquisition targets, rather than looking to go public as soon as they can.

Q: Any final thoughts for us?

A: My biggest thought is that if you haven't noticed enterprise technology powering the NASDAQ's historic rise juxtaposed against a terrifying economic backdrop, it's time to pay attention. And if you've only looked at public markets, it's time to take a look at earlier stage tech.

The economic growth of the next 10 years will be driven by the next Salesforce, Zoom, or even Bill.com far more than brick and mortar business openings. That value creation will happen within early stage tech. I couldn't be more excited to be living and breathing this sector!

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