How to Assess an Application Vendor's Financial Stability

As part of their due diligence, enterprises considering the purchase of business applications need to determine the financial viability of prospective vendors. Such an analysis is especially critical during bad economic times.

Factors Affecting a Vendor’s Financial Stability

As we’ve learned during the past few years, the future viability of a vendor is one of the most-critical criteria an enterprise should examine when selecting a business application. Indeed, it is particularly important as a criterion during a bad economy. Viability itself has many constituent parts:

- The senior executives’ experience
- The performance of the sales and marketing organizations
- The amount of R&D
- Geographic coverage
Strength of partnerships

Market segments

For more details on how Gartner assesses a vendor’s overall viability, see "Gartner's Vendor Rating Process: Using the Evaluations" and "Q&A for Gartner's Vendor Rating Research." As a subset, financial stability is one of the most-important factors, but it is also the hardest to assess with certainty.

Factors Affecting Vendor Financial Stability

The bedrock of vendor viability is financial performance. The financial stability of the vendor can be both a leading and trailing indicator. An incorrect product strategy or poor customer service will eventually manifest itself in the financial status of the vendor. At the same time, the vendor's ability to invest and keep its products competitive is a leading indicator of its future capabilities.

In today's economy, a vendor's viability can change quickly as a result of the vendor being acquired or even ceasing to trade. However, the limited data that publicly traded vendors are legally required to reveal makes financial stability particularly difficult to assess, and privately held companies are obligated to reveal even less financial data.

Data can become less reliable when things do not go well for a company. Accordingly, enterprises need to understand how financial stability can be assessed so that the hard questions are asked at least, if not fully answered.

The Evaluation Process

Use reports on market intelligence, assessments from investment banking analysts, vendor earnings calls and other financial reports, and, in some cases, information shared by the vendors' customers. Enterprises can use these sources of information for filling in the key metrics to estimate the likelihood a vendor will remain successful two or more years hence. When assessing the financial stability of business application software vendors, look at the following statistics and their trends:

- Last quarter's profit and the running 12-month total
- Last quarter's revenue and the running 12-month total
- Last quarter's new license fees and the running 12-month total
- Last quarter's service and maintenance fees and the running 12-month total
- Percentage of revenue spent on R&D during the past 12 months
- Number of new deals quarter over quarter
- Cash burn or generation rate quarter over quarter
- Net debt in the latest quarter and next debt payment — that is, how much matures and when
- Revenue per head count (employee yield)
- Number of sales staff and the running 12-month total
- Profit of two largest shareholders during the past 12 months
- Share price movement during the last 12 months
- Turnover of directors and executive officers

**Profit:** Review pro forma and generally accepted accounting principles (GAAP) results — there may be valid reasons why they differ. For example, the vendor may exclude extraordinary items. If GAAP (or the local equivalent for non-U.S. companies) and pro forma results differ consistently from year to year, view the vendor's revenue management skeptically. Also, take into account that recent acquisitions may have enhanced profitability and that the profit may come through divisions of the company unrelated to the software products you are considering. In these cases, the unprofitable software division may become a candidate for disposal, or the vendor may switch development resources more heavily to consulting and custom-built work.

**Revenue:** Review particularly the trend in revenue and how the vendor compares to its nearest competitors. Again, recent acquisitions could cloud the revenue picture. Enterprises can grow artificially by adding volume without profit.

**License Fees:** Business application vendors typically have at least three sources of revenue: software licenses, maintenance and services. New license revenue provides the fairest direct comparison of a vendor's performance with that of its competitors. Some vendors embed maintenance fees within their licenses (often referred to as "updates"), so be sure you are looking at new license revenue only, as maintenance revenue, which is an annuity stream, can cloud new product sales metrics.

**Service and Maintenance Fees:** This revenue indicates what the vendor derives from its customer base. It is a more stable and predictable source of revenue. A high ratio compared to license fees may lead the customer to become a "cash cow" for the vendor or for the vendor to slip into becoming a service provider, rather than a software author. An increase in professional service revenue relative to maintenance revenue
shows either more new customers or a desperate attempt to increase revenue in the face of declining license fees. Relative increases in maintenance fees show the vendor’s ability to keep customers; however, look back at the past 24 months, because most contracts are for a minimum of two to three years. Lastly, service and maintenance revenue typically follow new license sales trends, but lag approximately nine to 18 months. If new license sales are down for an extended period, maintenance and service fees will typically follow.

**Percentage of Revenue Spent on R&D:** R&D expenditures reveal a vendor’s interest in future product releases. Some enterprises fold the maintenance revenue into this figure on the grounds that software fault fixes are part of future product investment. If so, check whether they do, in fact, release new products or new versions at regular intervals.

**New Deals:** The value and volume of deals count. Determine the average deal size and its trend during the past 12 months. For example, a vendor that once made $100,000 per deal, but now makes $3,000 is likely to suffer in future performance — it may have heavily discounted the software to maintain high sales volumes, but left the old sales cost structure in place. In this scenario, a vendor that has been heavily discounting sales and has lower average deal prices needs to work harder to maintain sales levels. The cost of sales increases and typically lowers profit capability.

**Cash:** How much cash does the vendor burn? If it sold no more software, how long could it last? Question how the vendor accounts for reserves and counts costs. Preferably, reserves are in cash on hand, but it could come in the form of a long line of credit with no restrictions.

**Debt:** Many enterprises operate successfully with an appropriate level of debt. Don’t be put off by vendors that carry debt—it’s a fact of life. Concerns should be around short-term debt or liabilities (one big one is building lease exposures), which is a big issue for some vendors in the last year. This is due to reductions in staff, the length of contracts and the costs to exit from them. Also look at changes in the debt position, as well as key dates of maturity. One key factor is to track the timeline of debt rate to lower new license revenue. This could indicate a problem.

**Revenue per Head Count:** Enterprise productivity indicates a great deal about its efficiency, including efficiency of development, staffing levels and product, as opposed to service revenue. Compare the vendor with its main competitors during the past three years.
Number of Sales Staff: The sales staff is often the software industry’s equivalent of the “canary in the coal mine.” They are hired during times of growth and fired first during times of reductions. The exception, which will be easily determined, is when the vendor is moving toward a channel sales operation as a deliberate strategy.

Largest Shareholders’ Profit: The performance of major shareholders will determine the future of many enterprises. At the very least, watch how the shareholders perform. If they sell their assets, including shares in your vendor, you may be affected unduly.

Share Price: The market's movement reflects confidence in the vendor's future earnings. Do not use it as a sole guide, but it helps to see how the market views the vendor and whether it is succeeding or becoming a takeover target. This advice applies particularly to older listed companies. For public enterprises, which must make the information available, insider trades may indicate senior managers exiting the stock or vesting their options. Extremely low share price can be an indicator that the vendor might be a target for de-listing. This is a high caution, where share price can be a key factor.

Turnover of Directors and Executives: The rate of executive turnover indicates stability and confidence in a company. Senior management will look for greener pastures when they see the current product portfolio reaching the end of its life and opportunities for growth becoming limited.

Bottom Line: Vendor selection can have a major effect on the end user's organization. If the product fits perfectly, but the vendor is acquired or goes out of business within a year, the project and software investment can easily be put at risk. Due to the economic climate, financial stability should concern enterprises that are looking for assurances that they have made investments in business applications with reliable providers. To gauge financial stability, buyers should undertake a comparative review of a vendor's financial health, based on direct financial metrics such as revenue growth, cash position and profitability. They should also assess the overall viability of the vendor by looking at such factors as management team turnover, sales success and R&D expenditures. These metrics indicate the commitment of the vendor to competing in its chosen business application software market.

Acronym Key

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<thead>
<tr>
<th>Acronym</th>
<th>Definition</th>
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<tbody>
<tr>
<td>ERP</td>
<td>enterprise resource planning</td>
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<tr>
<td>GAAP</td>
<td>generally accepted accounting practices</td>
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<td>ROI</td>
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