

Maximizing Your Place on the Valuation Continuum

By Anthony Lembo

With the continuing economic malaise making growth and profitability challenging, many IT companies are rethinking their business models in the hopes of increasing their growth, profitability and valuation. One clear opportunity to do so lies in the cloud service and technologies sector.

Gartner forecasts that the infrastructure as a service (IaaS) cloud market segment will grow from \$4.3 billion in 2011 to \$6.2 billion in 2012, and reach close to \$14 billion by 2016. Gartner also expects software as a service (SaaS) and platform as a service (PaaS) cloud segments to continue growing from their current \$14 billion and \$1.2 billion run rates, respectively.

These forecasts bode well for companies in the cloud services market. With the high growth and recurring revenue potential found in the cloud, cloud companies are currently enjoying the benefit of higher valuation multiples relative to other IT Services companies that do not have strong cloud offerings.

The result is that the relationship between a firm's ratio of products and services offerings and its valuations can be depicted on a continuum such as the one that follows this VDI. On it, we see that valuation multiples increase when a company adds services to its offerings.

At one end of the spectrum is PC Connection, a leading multi-channel retailer of computers, electronics and industrial products with an enterprise value as a multiple of revenue (EV/Revenue) of .12x. At the other end is Rackspace, with its recurring data center cloud model and an EV/Revenue multiple that is a robust 7.75x. Other companies, which have product/service revenue mixes between the two extremes, fall somewhere in between.

Bottom line, when companies contemplate changes to their offerings and business models, they should consider how the changes might impact their position on this valuation continuum. And the closer they can get to the cloud, the more their efforts will be rewarded in higher valuations.

See the Appendix for the Valuation Continuum.