6 Fundraising tips for vertical SaaS founders

As businesses become more demanding, ‘Vertical SaaS’ will emerge as one of the fastest growing areas in business software. Unlike horizontal SaaS, where solutions aim to reach a wide range of businesses - vertical SaaS is purpose-built for specific industry niches, narrowing the potential market size whilst affording providers the opportunity to trade market size for market share.

As horizontal software solutions face an ever increasing threat of commoditization, the vertical players continue to build defensibility by solving specific business problems. They can embed themselves more deeply into their customers’ workflows via a broader stack of offerings including automation, intelligence and payment processing. At Notion, we’ve been obsessed with vertical SaaS for over a decade with investments in companies such as *Paddle*, *Mews*, *Easol*, *Vev* and many others.

Vertical SaaS founders face unique challenges when raising from VCs. As a vertical SaaS founder, here are six tips to consider when raising funds for your startup:

1. Explain the pain faced by your target industry

Many companies are still unaware of the simplicity vertical SaaS offers. Instead, they rely on a complex web of horizontal products and custom workarounds, cobbling together functionalities from various software tools to meet their industry-specific needs. Unfortunately, this approach leads to integration issues, causing significant losses in productivity and reliability.

Vertical SaaS steps in as an all-in-one solution, providing users with a tailored 'operating system' designed specifically for their needs. These products are not only more enjoyable to use, but also cost-effective and reliable. By focusing on the relevant user persona, vertical SaaS companies continually develop their offerings to address the core pain points of their customers. As investors, we seek conviction in your tool's ability to empower customers, while driving business growth.

2. Demonstrate how you'll build a $1B company

Potential investors in vertical SaaS companies often spend a lot of time debating market size. While horizontal players target anyone with a computer, vertical players usually tackle a tightly defined market.

The investor concerns are often justified – not every vertical will be large enough to create a $1B software company. A dedicated app for tree surgeons or mobile car wash operators may be too specific to reach $100M in revenue in less than a decade (a classic expectation in VC).

Many 'niches' may seem small at the outset, but are actually very large, under-catered, and begging for a dedicated solution: experiences (*Easol*), beauticians, convenience stores (*Statement*) and independent breweries and distilleries (*Bemakers*) are a few examples of those. These hidden-in-plain-sight markets often become even larger when considering the unique monetisation capabilities of vertical SaaS. Vertical SaaS often takes a 'layer cake' approach, with a subscription fee at the core but it's rarely the main revenue driver. In practice, payment processing is the biggest enabler in vertical SaaS.

3. Understand the value of payments

Owning the payment layer in vertical SaaS significantly enhances the value of vertical SaaS. For example, an SME with a £1M turnover would typically allocate no more than 5% of its budget to IT. Assuming a vertical SaaS company captures a 20% share of the overall IT budget and charges 1% of the turnover as a subscription fee, the fixed annual subscription value would be £10,000. However, if the product includes payment processing and charges a 2.5% fee (average for SMEs), the annual revenues would reach £25,000 (although at a lower gross margin) – 2.5x more plus an opportunity to grow with the business as it increases the turnover.

Leading vertical SaaS companies excel at combining subscription and payment processing revenue streams to create a compelling business model that extracts fair value from its users at a healthy margin and with a good degree of predictability.

When a business controls the flow of funds, it opens up additional monetization opportunities, including embedded lending, insurance, or foreign exchange. The data that vertical SaaS companies collect can also be leveraged to create more products. For example, a SaaS tool serving travel operators could establish a marketplace to connect supply (operators) and demand (consumers), while monetizing via a commissions model.

4. Mind the quality and diversity of revenue

Another common concern is the quality of the revenue. While traditional SaaS often charges a monthly subscription fee, generating a gross margin over 80%, a vertical software combines multiple revenue streams with varying levels of margin and predictability.

Subscriptions are seen as high quality and offer better visibility of potential revenues. Conversely, good vertical SaaS companies see 50-80% of their revenue come from processing (payments from individual transactions), which can cause problems with predictability, especially economically turbulent times. Many VC investors struggle to value companies that rely on a ‘mixed bag’ of revenue streams.

At *Notion* we see the company’s potential to sit on top of payments flow as a key criteria. Vertical SaaS founders can increase their chances of raising investment by deeply understanding their market size, present and future monetisation opportunities, and the sequence to introduce users/customers to the overall revenue stack. *Mews.com* is a good example of a Vertical SaaS business with a diverse set of revenue streams. They started as a subscription + payment processing business. As their user base increased, they introduced marketplace revenues and embedded lending. Each revenue stream further increases the size of the total addressable market within their vertical.

5. Show how to de-risk the product-market-fit concerns

The bane of every startup is product market fit, particularly for bigger tools. For example, everyone uses spreadsheets. As an early stage spreadsheets startup with limited resources, how do you go to market efficiently targeting all those users? This can involve an expensive process of forcing your way into the personas that the product resonates with best.

For vertical software, the journey to product market fit is less fraught. The buyer/user persona may change, and you may need to iterate based on that, but the smaller market enables you to demonstrate return on investment. This quicker journey to market fit is appealing to VCs. Pivoting isn't trivial, so more scrutiny is paid to the early evidence of product-market-fit through early users/design partners.

6. Demonstrate that you will change the shape of your market

In the early days it's ultimately about the founding team, who have unique insight into their market. Investors want to see why you're the best positioned to disrupt your target industry. It's rare, but occasionally founders will convey that their entire careers have led them to a singular mission: to fundamentally redefine their industry. A notable example is *Ben & Lisa Simpson* at *Easol.com*. Despite the challenges of COVID-19, which caused their market to vanish overnight, they remained steadfast in building their vertical SaaS platform for experiences creators. Their resilience has propelled their tool on a rapid trajectory towards market leadership.

If you're currently building a vertical SaaS tool and dreaming of revolutionising your market please get in touch – we'd love to hear from you!

Kamil Mieczakowski is a Partner at *Notion Capital*.

Article by KAMIL MIECZAKOWSKI