



## *Assessing Quality of Revenue: Critical to Success in Search Fund Acquisitions*

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### Abstract

This article explores the critical importance of assessing a target company's quality of revenue by searchers and existing operating company CEOs. While traditional financial due diligence focuses on the quality of earnings, this paper fosters the notion that understanding the quality of revenue offers a more accurate and forward-looking assessment of a company's potential for sustainable growth. Additionally, the paper stresses the importance of a Quality of Revenue assessment, a comprehensive approach that evaluates nine core operational and functional drivers of future revenue growth. By combining these methods, searchers can make more informed decisions, identify risks and opportunities early in the acquisition process, and ultimately enhance their ability to generate consistent, long-term returns.

## INTRODUCTION

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The ability to assess a company's capacity for sustainable revenue growth is crucial for searchers. Organic revenue growth drives value creation, enabling investments in people, technology, and processes, and is often more impactful than cost-cutting or financial adjustments. Unlike traditional Quality of Earnings (QofE) analysis, which focuses on past performance, assessing the quality of revenue offers a forward-looking view of a company's true growth potential. By examining key operational drivers, this approach helps searchers make informed decisions, identify growth opportunities, and mitigate risks, ultimately leading to more reliable and sustainable business outcomes.

## WHY REVENUE QUALITY IS CRITICAL FOR ACQUISITION SUCCESS?

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The ability to reliably and accurately assess a company's capacity to generate sustainable revenue growth and achieve targeted returns is among the most important considerations searchers are faced with. Organic revenue growth is the primary basis for creating value in today's economic environment. Future cash flows are the most capital efficient enabler of growth by allowing for investment in people, improved processes, technology, and M&A.

The more reliable revenue growth is, the greater the value creation opportunities. Many would say the ability to grow revenues organically has created more enterprise value than efforts to reduce costs, multiple arbitrage, debt pay-downs, etc.

## THE LIMITATIONS OF QUALITY OF EARNINGS ANALYSIS

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Predicting the future growth potential of a firm is made difficult by the fact that traditional Quality of Earnings analysis in the due diligence and valuation process are extremely limited in their ability to shed light on the key drivers of future revenue growth. A Quality of Earnings analysis is a financial accounting exercise whose primary purpose is to assess how a business accumulates revenues – such as cash or non-cash, recurring or nonrecurring revenues – from its core operations. This helps searchers and investors alike assess the future cash flow, revenue, and earnings potential of the business – which are the basis of firm value and the price they will pay. Unfortunately, a Quality of Earnings analysis typically does not include cohort analyses as a standard practice as its primary focus is on evaluating earnings from an accounting and financial statement perspective. Additionally, the Quality of Earnings analysis is missing a lot of critical information about future revenues. For example, the forward-looking revenue pipeline and financial forecast, although subjective, are not included in the Quality of Earnings analysis.

## QUALITY OF REVENUE: A BETTER WAY FORWARD

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**Benefits of a Quality of Revenue Assessment.** A Quality of Revenue assessment is a better way for searchers to assess a company's ability to generate sustainable revenue growth and hit financial targets than traditional financial analysis of the quality of earnings. A Quality of Revenue assessment is a forward-looking analysis that objectively grades a company based on

its capabilities in core operational and functional drivers of future revenue growth potential areas that are key to sustainable revenue generation and hitting revenue growth targets (and, ultimately, earnings targets).

The benefits include, but are not limited to:

- **Objective Benchmarking:** The Quality of Revenue assessment provides an unbiased evaluation of a company’s revenue cycle by comparing it against industry best practices and similar high-growth companies. This “apples to apples” comparison identifies gaps, weaknesses, and growth opportunities.
- **Comprehensive Revenue Evaluation:** The assessment covers nine core operational and functional drivers crucial to future revenue growth: Strategy, Culture, Business Process, Revenue Operations, Technology, Customer Experience, Revenue Management, Marketing, Product, and Pricing. These areas are assessed against 40 key underlying drivers, allowing for a detailed analysis of each function's contribution to overall revenue generation.
- **Forward-Looking Analysis:** Unlike traditional financial assessments that focus on historical performance, a Quality of Revenue assessment evaluates the company’s capabilities to meet future revenue growth targets. This proactive approach grades the business on its potential to generate sustainable revenue and achieve set growth goals.
- **Risk Identification and Actionable Insights:** The Quality of Revenue assessment highlights root causes of revenue underperformance and potential risks in the revenue plan. It provides a roadmap with actionable steps to mitigate risks and unlock the full revenue potential of the business.
- **Performance Monitoring and Continuous Improvement:** The assessment’s objective scoring system allows companies to measure, monitor, and improve their revenue generation processes over time. This ongoing process improvement ensures that the company adapts and evolves to meet its growth targets consistently.

**QUALITY OF REVENUE EXAMINES DIFFERENT VARIABLES IN THE GROWTH EQUATION**

QUALITY OF EARNINGS	QUALITY OF REVENUE GENERATION
Cash Flow Analysis	Alignment Of Revenue Teams, Systems and Processes
Financial Statement Analysis	Brand Preference and The Right to Win
Net Working Capital Analysis	Growth Strategy, Planning, And Resource Allocation
Revenue Recognition	Revenue Generation Culture
Expense Recognition	Willingness And Ability to Change
Non-Recurring Items	Customer Relationship and Expansion Management
Accounting Policies	Revenue Funnel Management

Related Party Transactions

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Accounting Quality

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Compliance

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AN EXTRAPOLATION OF HISTORICAL REVENUE  
AND EARNINGS RESULTS FROM  
FINANCIAL STATEMENTS

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Pricing Power, Structure, And Governance

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Product Development Methods & Effectiveness

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Utilization Of CRM And Customer Analytics

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VISIBILITY INTO THE CORE OPERATIONAL AND  
FUNCTIONAL DRIVERS OF FUTURE REVENUE  
& CASH FLOW GENERATION

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Unlike QofE, a Quality of Revenue assessment will diagnose the interrelationships of a business model and pinpoint where corrective – or opportunistic – action is needed. For example:

- Aligning the commercial systems, operations, and processes that support the revenue cycle – or Revenue Operations - can contribute five to ten points of profit contribution to the bottom line in the short term and improve individual rep productivity by over 50% over a few sales periods.
- More disciplined and optimized pricing can expand margins by 3-10% with existing resources and improve earnings multiples with limited investment.
- Revenue leakage, shrinkage, and slippage between booked and realized revenues causes between 1 to 5% of EBITDA to flow unnoticed out of companies because they do not have their contract management and payment follow-up processes completely in order.
- Automating and optimizing the lead-to-cash cycle can grow revenues by 5%, reduce costs to sell by 5%, improve forecast accuracy by 34%, reduce billing errors and disputes on orders by 35%, and shrink the time it takes to collect cash by over 10%.
- Tuning the target company’s commercial architecture – the design of the sales force and they key incentives, quotas, and roles, coverage, and engagement rules within it – to take better advantage of digital technology can double the speed, engagement, and performance of the front-line sellers.

## HOW TO CONDUCT A QUALITY OF REVENUE ASSESSMENT:

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Begin the Quality of Revenue assessment by benchmarking the target company’s operational and functional drivers against a comparable, high-growth company within the same industry. Focus on the alignment of functional teams, systems, processes, and operations that support the full revenue cycle across people, product, process, and technology. Additionally, examine the strength of the core functional capabilities in marketing, product, and revenue cycle management. Evaluate the strength of growth leadership and the growth strategy, planning process, and culture they have instilled. Ensure to distill the maturity of core operational

capabilities in pricing, analytics, performance measurement, and customer experience management.

This comparison provides an “apples to apples” view of how the target company’s revenue operations stack up against industry leaders. By evaluating the revenue cycle through the lens of established best practices, you can objectively identify gaps and weaknesses that may be hindering growth. This step ensures that your assessment is grounded in real-world standards and sets a clear baseline for evaluation and improvement.

**Evaluate Core Business Functions:** Assess each of the business functions using the key drivers to get an in-depth view of the company’s strengths and weaknesses.

Focus areas can include:

QUALITY OF REVENUE ASSESSMENT CRITERIA					
Strategy	Clarity of Vision	Strategic Plan	Right to Win	Target Market/ TAM	Revenue Roadmap
Culture	Alignment of Key Staff	Culture of Revenue Generation	Ability to Change	Core Values	
Business Process	KPI's/OKR's	Value Proposition Delivery	Customer Onboarding	Employee Goals	
Revenue Operations	Core Enabling Technologies	Alignment of process	Alignment of People	Commercial Architecture	Sales Methodology
Customer Experience	Preference	Engagement	Service & Support Function	Customer Service Talent	
Revenue Management	Revenue Goals	Forecast Accuracy	Sales Management	Sales Talent Quality	Sales Process
Marketing Management	Funnel Management	Channel Optimization	CRM	Content Management System (CMS)	Campaign Management
Product Management	Product Market Fit	Product Quality	Product Management	Product Development	
Pricing	Pricing Structure	Discipline & Governance	Accuracy		

Source: Table Courtesy of Brainheart Growth

**Identify Gaps and Risks:** The assessment process helps reveal critical gaps and risks within the target company’s revenue cycle by comparing the target company’s performance to industry benchmarks. By drilling down into the nine core business functions and their underlying drivers, you can identify the root causes of underperformance and surface potential threats to your modeled revenue goals. This diagnostic approach highlights specific areas that need attention, such as misalignments in strategy, ineffective sales processes, or weaknesses in customer experience. Understanding these gaps allows you to evaluate transaction risks and prioritize initiatives that directly address the factors limiting future revenue potential.

**Develop a Go/No-Go Decision Framework:** Utilize the findings from the Quality of Revenue assessment during the diligence phase to inform acquisition or investment decisions. By revealing the underlying drivers of revenue and potential risks, the assessment supports a data-driven approach to deciding whether to move forward with an investment or acquisition. If a “Go” decision is reached, the assessment can serve as a foundation for engaging a third-party provider to conduct a more comprehensive evaluation. This deeper analysis will help create a targeted roadmap with action steps designed to unlock growth and optimize the company's revenue potential.

**Implement and Monitor:** After identifying key areas for improvement, put the insights from the Quality of Revenue assessment into action by implementing targeted initiatives aimed at closing performance gaps. Establish clear metrics and monitoring systems to track progress over time, using the assessment’s objective scoring as a benchmark. This continuous monitoring not only helps measure the impact of your improvement efforts but also fosters an environment of ongoing process optimization. Regularly revisiting the assessment criteria ensures that your company remains aligned with best practices and consistently evolves its revenue strategy to meet growth targets.

## CONCLUSION

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Those in search of a company to acquire can utilize a Quality of Revenue analysis during preliminary diligence by identifying a company in a similar industry with higher growth, then benchmarking the 9-core operational and functional drivers of the target in comparison to the company. This can identify early on any gaps or weaknesses in the revenue cycle. Revealing the underlying drivers of revenue as well as surfacing any cracks in the revenue generating foundation can highlight the risks and aid in making an informed Go/No Go decision. If a Go decision is reached, a third-party provider of Quality of Revenue Analyses can then be engaged. Utilizing this tool can assist in developing a roadmap and action steps to unlock full growth potential.

Assessing the quality of revenue is essential for searchers seeking to understand a company's true growth potential. By going beyond traditional financial metrics and focusing on the sustainability and reliability of revenue streams, searchers can make more informed decisions that lead to long-term value creation. Tools like Cohort Analysis and Quality of Revenue assessments provide deeper insights into the operational drivers of future growth, enabling acquirers to identify risks, capitalize on opportunities, and ultimately achieve more predictable and sustainable business outcomes.

## References

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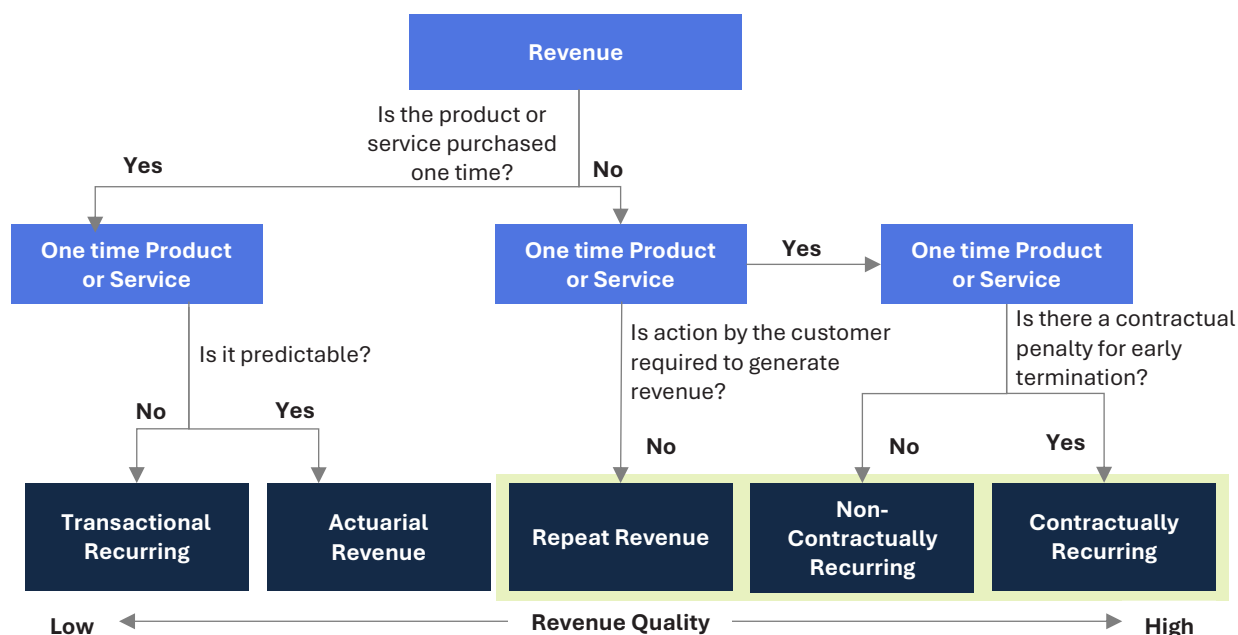
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## APPENDIX A: RECURRING REVENUE DILIGENCE FOR SEARCHERS



## APPENDIX B: CONDUCTING A COHORT ANALYSIS

A Cohort Analysis provides a comprehensive understanding of revenue quality by examining the sustainability of revenue streams, especially in businesses where customer behavior and retention are critical. By grouping customers based on common characteristics, such as the date of acquisition, a Cohort Analysis allows for the detailed tracking of how different customer groups perform over time in terms of retention, revenue contribution, and profitability. This approach helps determine whether revenue growth is driven by acquiring new customers or by retaining and upselling existing ones, which is often considered higher quality and more sustainable. Although not typically included in traditional Quality of Earnings (QofE) analysis, Cohort Analysis can complement QofE by offering deeper insights into the impact of churn and retention, distinguishing between revenue from ongoing customer relationships versus one-time transactions. It reveals whether earnings growth is due to sustainable improvements in retention or short-term gains from new acquisitions, adding valuable context to revenue assessments.

## KEY METRICS

**Customer Retention:** Analyzing the count of customers that remain in each cohort by period can identify patterns and lead to further analysis. Examples include the product usage, touch points, and service level of churned versus retained logos. Identifying the reasons behind strong cohorts and understanding churn causes can lead to optimization of logo retention and allow for tracking of cohort sensitivity to any implemented changes.

**Revenue Retention:** The retention rate can be determined by comparing revenue in each period to the initial period. Revenue decay can be identified if revenue is decreasing over time indicating churn or reduced customer engagement. Revenue growth can be identified as factors which could indicate upselling or cross selling.

**Gross Revenue Retention:** total the dollar retention after accounting for churn and decay.

**Net Revenue Retention:** adding Gross Dollar Retention to the growth of the existing customer base.

These metrics can be benchmarked against industry averages during the diligence and valuation process in making a Go/No Go decision, assist in coming to the right valuation, and model achievable forecasts.

Some common industry metrics are listed below:

Business Services Metrics (Indicative)			
Score	Recurring Revenue	Tailwinds YoY Growth /GDP	Operating Leverage
High	> 65%	> 2x GDP	>3
Medium	35%-64%	1.5x-2x GDP	1.5-3
Low	< 35%	< 1.5x GDP	<1.5

SaaS Metrics					
Score	Net Revenue Retention	Gross Revenue Retention	ARR Growth	Expansion ARR/Total ARR Growth	EBITDA Margin
High	> 105%	> 100%	> 35%	> 33%	> 25%
Medium	100%-104%	80%-99%	23%-34%	30%-33%	15%-25%
Low	< 100%	<80%	<23%	<30%	> 25%

