

Road to Next

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Foreword & executive summary

The burgeoning enterprise software segment of the expansion-stage ecosystem has rarely experienced such an acceleration of investment, leading to important considerations for many companies

Themes & key findings for this issue:

Amid a record-setting, red-hot investment environment, enterprise software companies stand out: By midyear 2021, expansion-stage deal value for this sector had already set a new high at \$21.7 billion, exceeding any prior annual tallies, according to PitchBook.

The proliferation of hybrid and fully remote workflows is prompting swifter adoption and innovation: Digitization is penetrating further into most sectors. Niche needs are also introducing new market opportunities in which incumbent expansion-stage companies can flourish as well as brand-new startups to target.

Implications for tax and regulations pertaining to tech companies are deepening: Although it remains to be seen what comes of ongoing global coordination regarding tax schema and regulations for tech companies, evolving work models will also require expansion-stage companies to grapple with additional tax implications from a distributed workforce.

Deloitte and PitchBook have collaborated to produce a unique methodology for the *Road to Next* series, in order to better analyze a new segment of companies that emerged in the 2010s. Dubbing this segment the expansion stage, the methodology utilizes investment data restricted to late-stage VC, PE growth, and private corporate financing. In addition, companies must still be privately held by aforementioned investment firms.

As digitization spreads throughout the vast ecosystem of private and public companies, it is taking many different forms across sectors and market segments. Enterprise software companies (those serving business/workflow/automation segments) are seizing emerging opportunities, especially those at the expansion stage that retain the necessary nimbleness and scale to move into new market categories. As a result, enterprise

software companies at this stage have raked in an already-record level of investment, looking to capitalize on not only a highly active funding environment but also avenues that are opening as the world adapts to the ongoing COVID-19 pandemic. Such rapid growth, however, does entail managing significant change, particularly in the realm of evolving digital service taxes and policies that specifically affect B2B software providers.



Heather Gates
Audit & Assurance Private Growth Leader, Deloitte & Touche LLP

With more than 30 years of financial services experience, Heather serves as the national Private Growth leader with oversight of the Deloitte Private, Emerging Growth Company, and Private Equity businesses within Audit & Assurance.

"The digitization of everything has resulted in a massive uptick in the growth trajectory for certain enterprise companies."



Gordon Perl
National and Silicon Valley Tax Leader for Emerging Growth Practice, Deloitte Tax LLP

With more than 20 years of public accounting experience, Gordon Perl serves as the Silicon Valley Tax Leader for the Deloitte Private & Emerging Growth Practice. His clients range from large multinational corporations to IPO-centered businesses.

"At the expansion stage, questions around indirect taxes and potential tax exposure become even more pressing."



Mark D. Chao
Managing Director, Multistate Tax Practice, Deloitte Tax LLP

Mark has 35 years of Big 4 experience and has specialized in multistate taxes for 30 years. Nationally, Mark serves as the Multistate Tax leader for Deloitte Private. He serves clients in a wide range of industries including entertainment and interactive gaming.

"Digital service taxes are increasingly popular, even for existing companies in rapid growth phase. Revisiting what may be taxable will be a necessity."

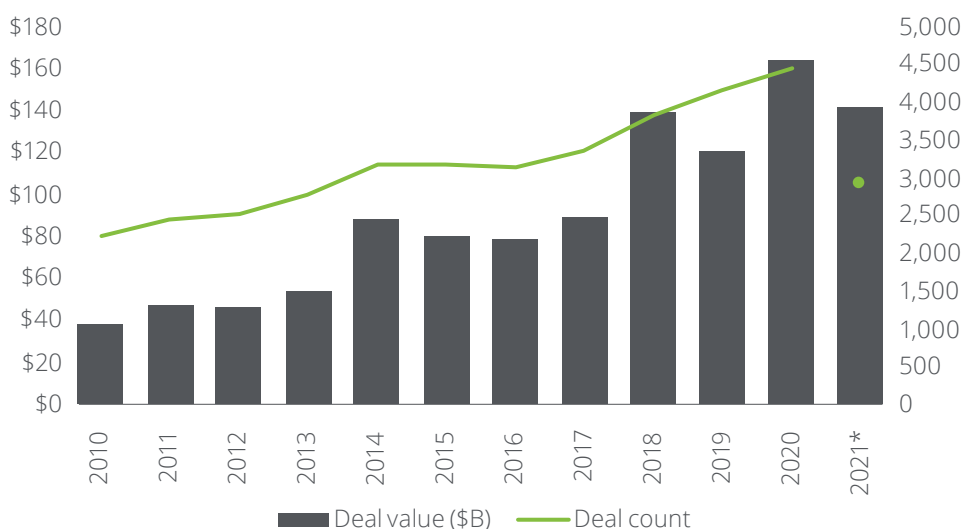
Market trends

Funding has rarely flowed so strongly across the entire expansion stage—especially the enterprise space

The entire expansion-stage ecosystem is flush with capital. Halfway through 2021, this cohort of companies has already amassed more than \$140 billion across just shy of 2,900 completed financings. Even if H2 closes on half the deal value of H1, 2021 would still record well over \$200 billion. Multiple segments of the expansion-stage ecosystem are notching new quarterly highs in financing volume, but a particularly active sector has been enterprise software. The space has already seen a new high in 2021, with aggregate deal value at \$21.7 billion across 443 completed transactions. Both tallies speak to a record pace of dealmaking across the space.

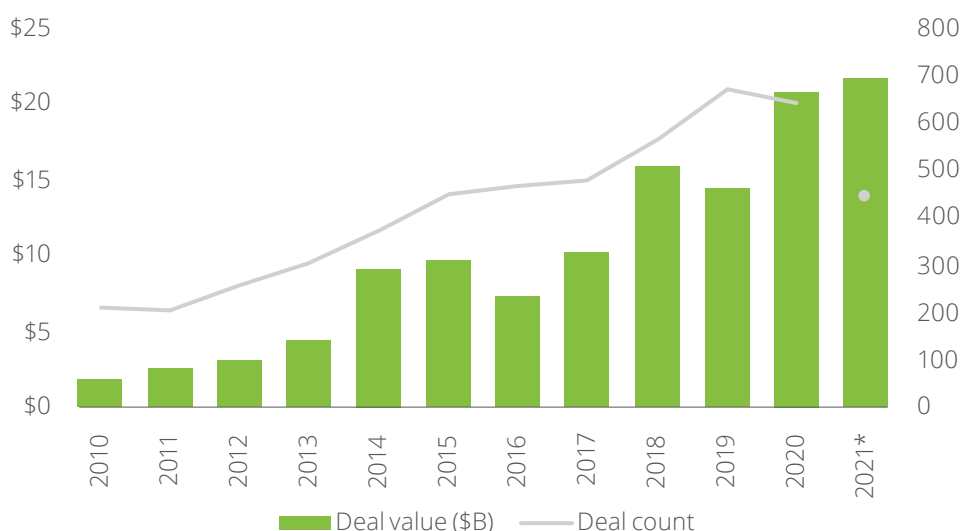
Underlying drivers of such an influx of capital abound. It is well known that the COVID-19 pandemic and the policies enacted to combat its spread have accelerated investment into digitization. They also benefited many enterprise software companies' business prospects. However, beyond that unique factor, the sheer expanse of market opportunities across the entire space—from the novel creation of products or services to the automation of previously manual, arduous processes—has rarely been larger. As a recent *Deloitte Tax Transformations Trends* case study has shown, improving workforce productivity topped the list of concerns among executives across C-suites, to cite just one backdrop example.¹ In addition, as use cases broaden and regulations and tax policies change, complexity increases. This, in turn, can often prompt the creation of new tools to address any gaps. For example, compliance systems will require updates to address the expanded definition of digital services subject to sales/use tax, which is increasingly common across multiple jurisdictions.

Expansion-stage deal activity



Source: PitchBook | Geography: US
*As of June 30, 2021

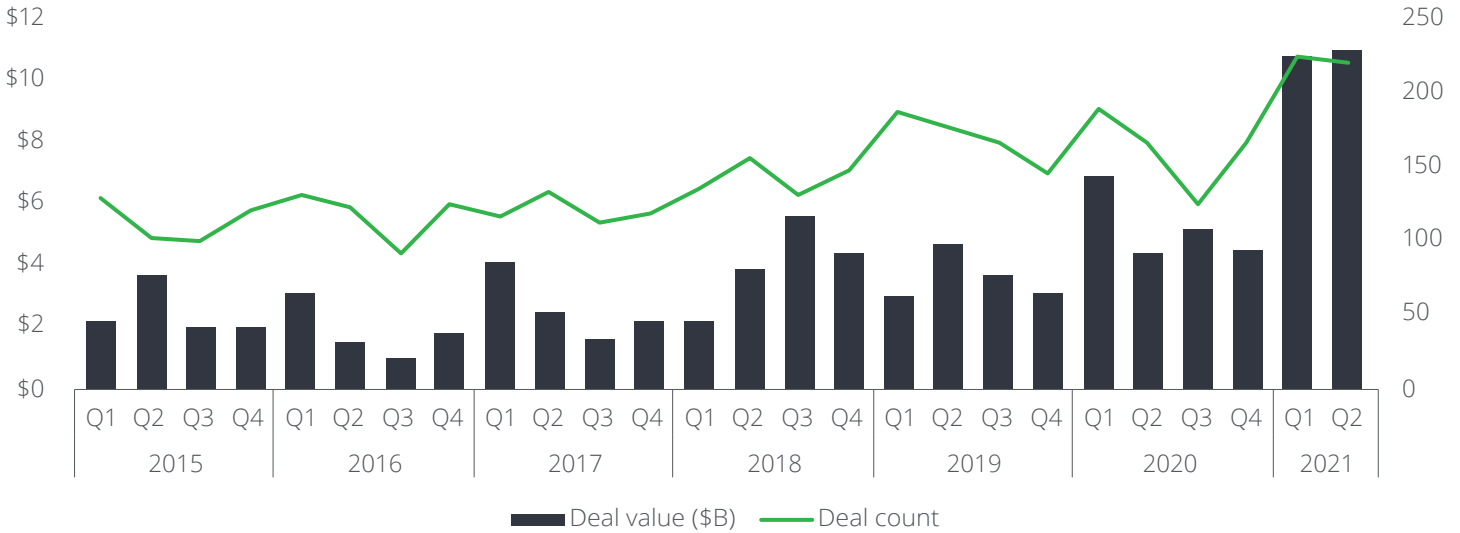
Enterprise software expansion-stage deal activity



Source: PitchBook | Geography: US
*As of June 30, 2021

1: Deloitte, *Tax Transformation Trends Survey*, July 20, 2021.

Enterprise software expansion-stage deal activity



Source: PitchBook | Geography: US
*As of June 30, 2021

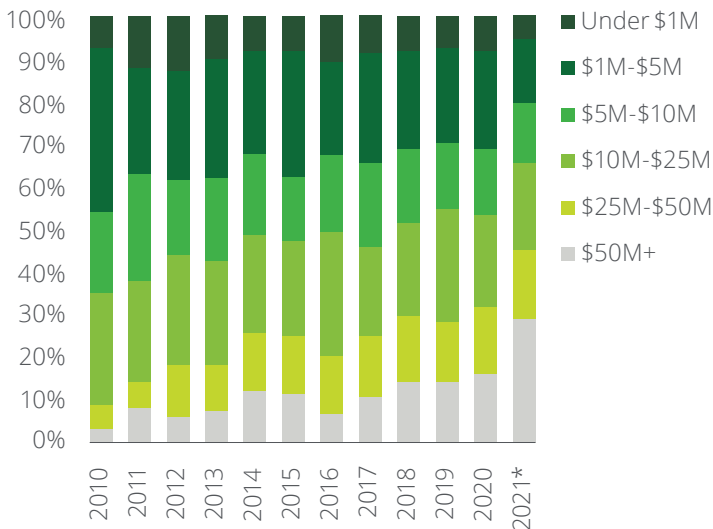
New niches abound as incumbents raise opportunistically

It is still common for even modern software companies to have overly manual processes. Small to medium-sized businesses (SMBs) have often been unable

to find solutions that are effective, versatile, and reasonably priced enough to justify revamping their tech stack. Now, especially after adoption became imperative due to the COVID-19 pandemic, more companies are pushing into this rapidly expanding market opportunity to provide those solutions. Much of this relatively new arena entails

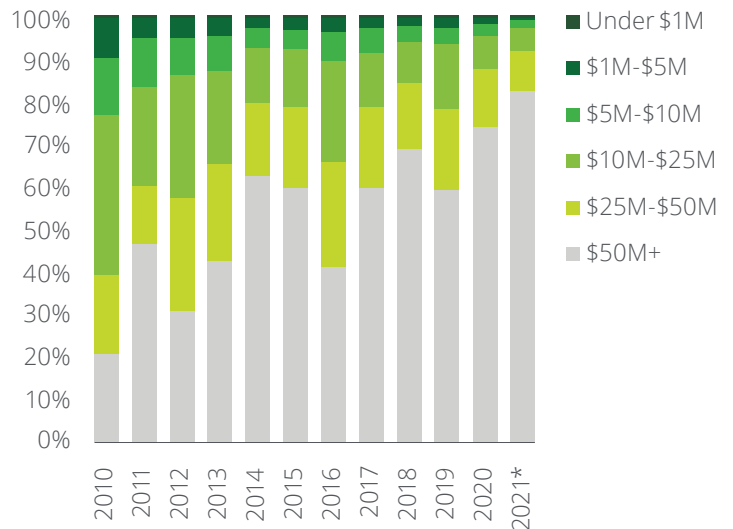
extracting as much value from legacy processes and tools as possible, seeking to bridge the gap between prior systems to newer, often fully cloud-based services. This approach, often rendered more cost-effective by outsourcing, can be more palatable to executives who have postponed modernizing their tech stacks due to budget constraints.

Enterprise software expansion-stage deals (#) by size



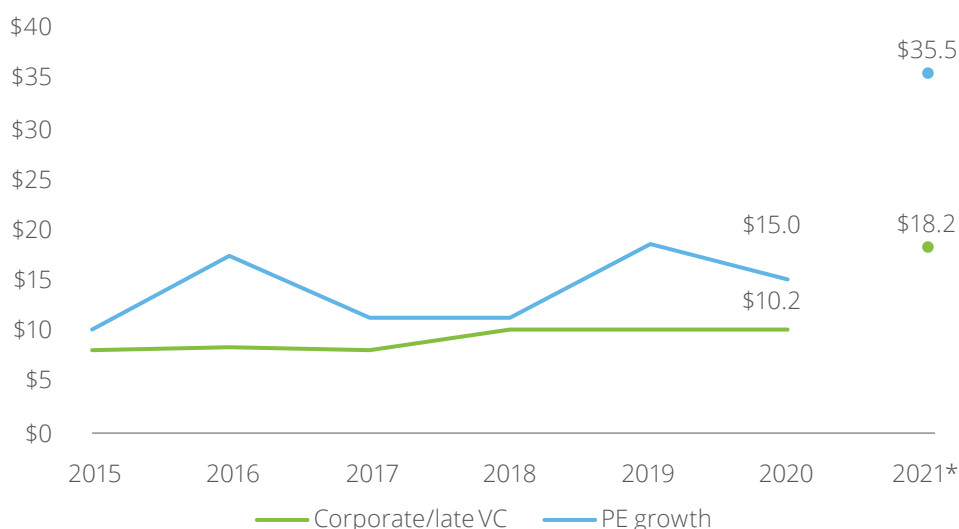
Source: PitchBook | Geography: US
*As of June 30, 2021

Enterprise software expansion-stage deals (\$) by size



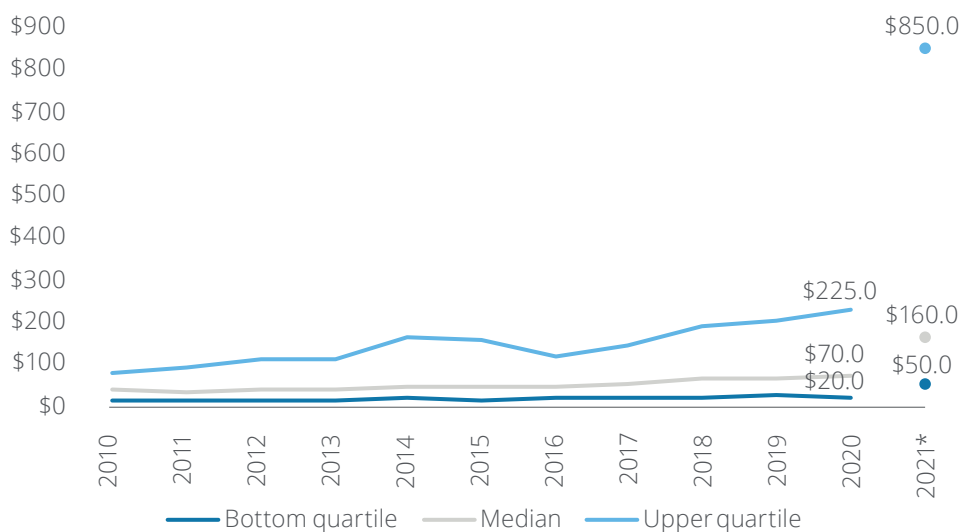
Source: PitchBook | Geography: US
*As of June 30, 2021

Median deal size (\$M) for enterprise software expansion-stage companies by deal type



Source: PitchBook | Geography: US
*As of June 30, 2021

Quartile range of pre-money valuations (\$M) for enterprise software expansion-stage companies



Source: PitchBook | Geography: US
*As of June 30, 2021

"Even for early-stage startups, failing to prepare for indirect tax burden can have an impact on margins from day one."

Mark Chao

Managing Director, Multistate Tax Practice
Deloitte Tax LLP

More advanced organizations are exploring the forefront of technical innovation across the practice of DevOps by looking to provide machine learning-powered, predictive discovery platforms with wide-ranging capabilities. An example would be the ability to find patterns in supply chains and build in crucial redundancies to withstand shocks like the one COVID-19 presented. Beyond aiding better forecasting, enterprise software companies are also pushing to offer platforms equipped with advanced analytics, automation, and AI to layer over multifarious workflows and processes, processing the steps of decision making to uncover internal and external forces and monitor outcomes. Such output often requires the input of vast amounts of data, including bits of information that were not often prioritized before. Silos of raw data are being connected to unify a holistic picture of processes and systems. Breaking perimeters often aligns with the growing adoption of zero-trust cybersecurity policies, especially as hybrid work models proliferate. As noted in the most recent *Deloitte Tech Trends* report, the merging of different work environments across homes and offices will require monitoring of access requests as well as continuous validation based on all available data points related to the action any user is undertaking in requesting access.²

These are just a few of the budding niches that continue to offer plenty of opportunity for enterprising founders and startups to empower businesses and workers worldwide. And as the flood of capital into the space goes, there is no shortage of money from investors eager to gain exposure to this dynamic space and expansion-stage companies tackling these problems. This explains the surge in median deal sizes across every expansion-stage transaction type, particularly the corporate and late-stage venture arena, as well as the rocketing valuations; the upper quartile has surged close to 3.8x between 2020 and the first half of 2021. This profusion of capital is coming in handy as companies scale but also must grapple with increasing tax and regulatory burdens that accompany growth and advent of digital service taxes. In particular, indirect taxes may result in cash outlays if not properly addressed.

2: Deloitte, *Deloitte Tech Trends 2021*, July 20, 2021.

Capital is recycling back into the segment as investor base diversifies and expands

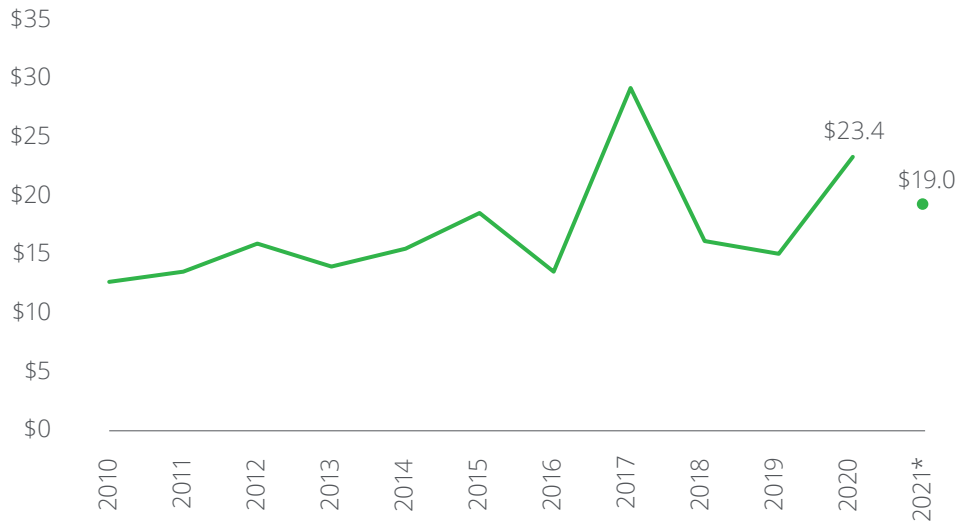
A key driver behind the record sums of investment is the broadening and diversification of the investor base. Corporates and nontraditional investment firms remain as active as ever across the space, the former participating in over \$7 billion of transactional value and the latter well over \$11 billion. Expansion-stage companies that are still actively raising rounds themselves are also starting to back more of their peers (in terms of size). In 2020, expansion-stage companies investing in enterprise software companies at the same stage participated in 56 completed deals for \$7.4 billion in aggregate deal value. Midway through 2021, they have already eclipsed that latter mark. Both going public and such investments require careful management and much preparation on the part of expansion-stage companies. For those looking to do either, ample preparation is necessary to avoid issues with varying regulations and policies down the road that could have financial implications, especially with regard to evolving taxes for business software providers.

"When preparing for an IPO, companies will have to ensure they have sufficiently long-running and adequate documentation of financial results to meet accounting standards for publicly listed companies, as well as proper controls and systems in the areas of corporate, indirect, and international taxes."

Gordon Perl

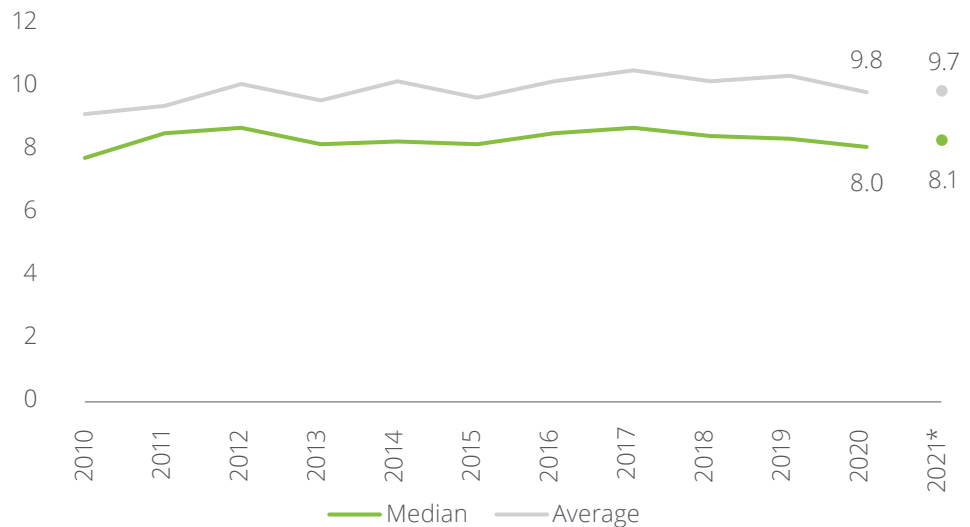
National and Silicon Valley Tax Leader for the Emerging Growth Practice, Deloitte Tax LLP

Median revenue (\$M) for enterprise software expansion-stage companies



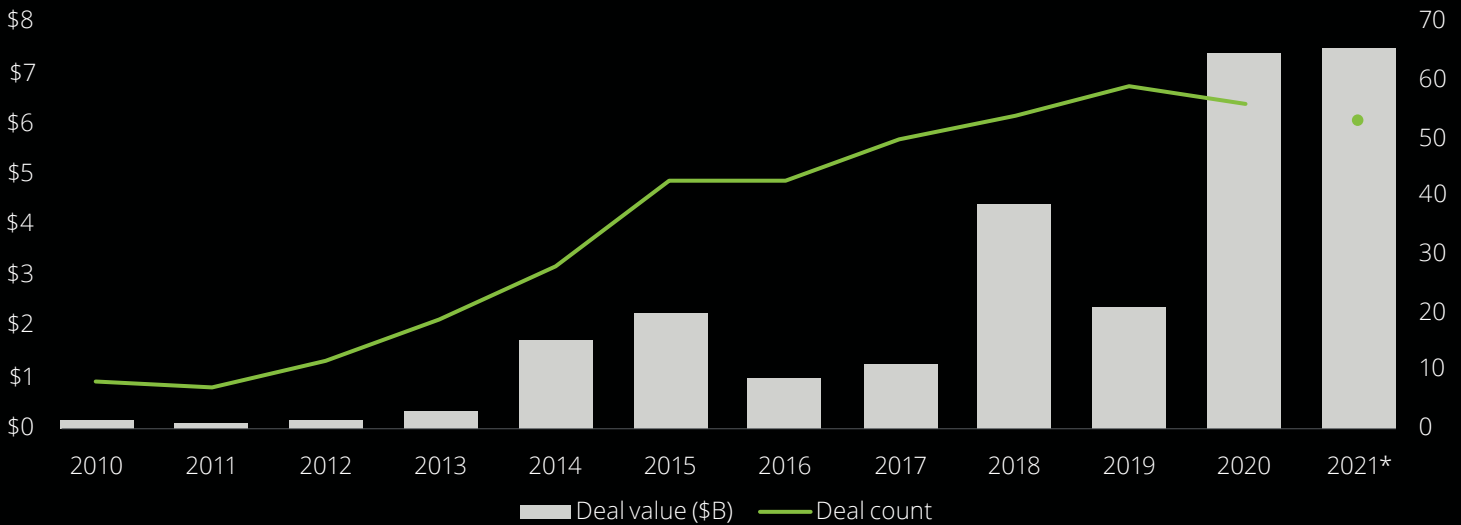
Source: PitchBook | Geography: US
*As of June 30, 2021

Median and average age (years) of enterprise software expansion-stage companies at time of expansion



Source: PitchBook | Geography: US
*As of June 30, 2021

Enterprise software expansion-stage deal activity with expansion-stage company participation



Source: PitchBook | Geography: US

*As of June 30, 2021

Note: These expansion-stage financings had at least one expansion-stage company participate as an investor.

"When it comes to different jurisdictions' varying standards, there is no one size fits all. Each jurisdiction must be examined in turn for tax implications, and these larger software companies are no exception."

Gordon Perl

National and Silicon Valley Tax Leader for the Emerging Growth Practice, Deloitte Tax LLP

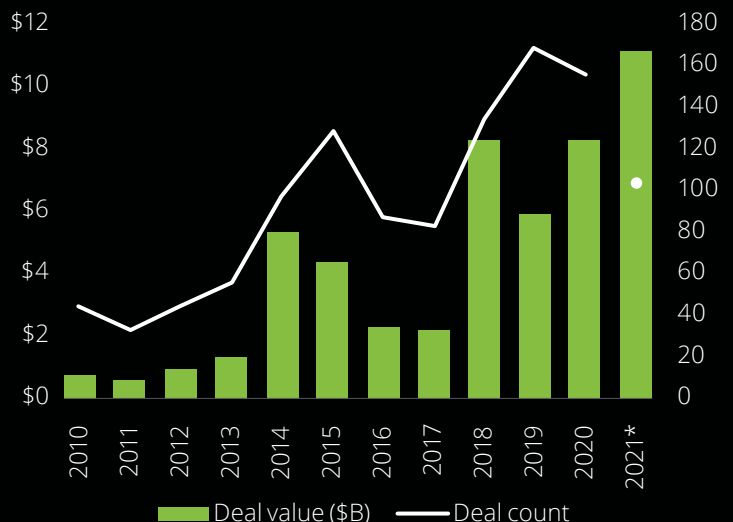
Enterprise software expansion-stage deal activity with corporate participation



Source: PitchBook | Geography: US

*As of June 30, 2021

Enterprise software expansion-stage deal activity with nontraditional investor participation



Source: PitchBook | Geography: US

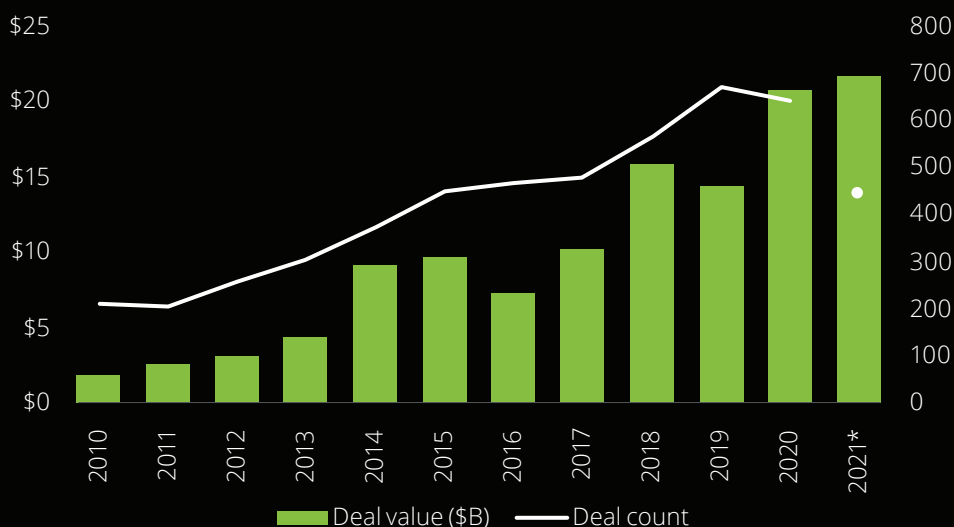
*As of June 30, 2021

Highlights across investment trends

This edition of the *Road to Next* series explores how investment into enterprise software has trended over time, especially under the accelerating influence of remote adoption. Digitization has proliferated at a quickening pace across multiple sectors and market segments. This has created

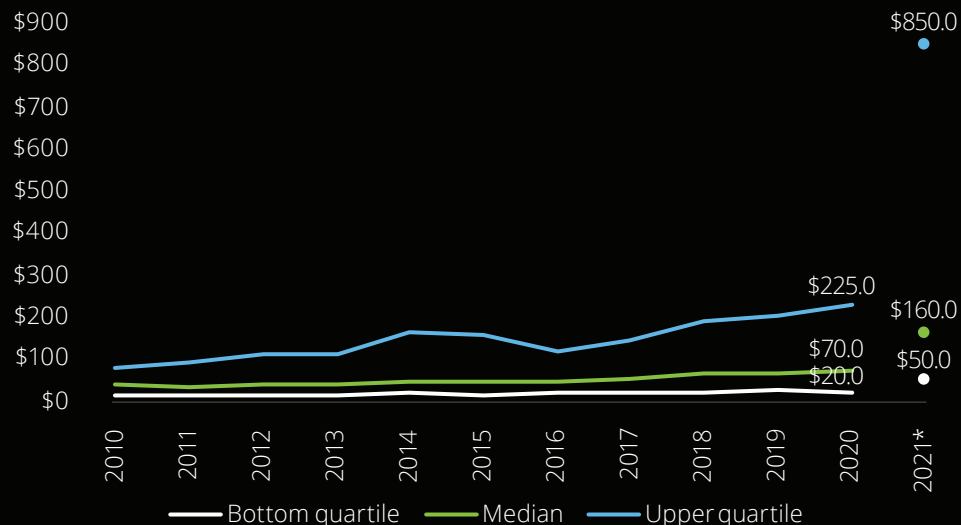
significant business opportunities for extant expansion-stage companies and new niches for startups to target and swiftly grow as previously underserved companies look to invest in their tech stacks, thereby reaping new gains in efficiency and productivity.

Enterprise software expansion-stage deal activity



Source: PitchBook | Geography: US
*As of June 30, 2021

Quartile range of pre-money valuations (\$M) for expansion-stage enterprise software companies



Source: PitchBook | Geography: US
*As of June 30, 2021

\$21.7B

2021 has already seen a record sum invested into enterprise software expansion-stage companies.

51%

Nontraditional firms seeking more exposure have participated in deals that amassed over half of all deal value closed in H1 2021.

53

By midyear, expansion-stage companies have already closed nearly as many deals with other companies at this stage as in the whole of 2020.

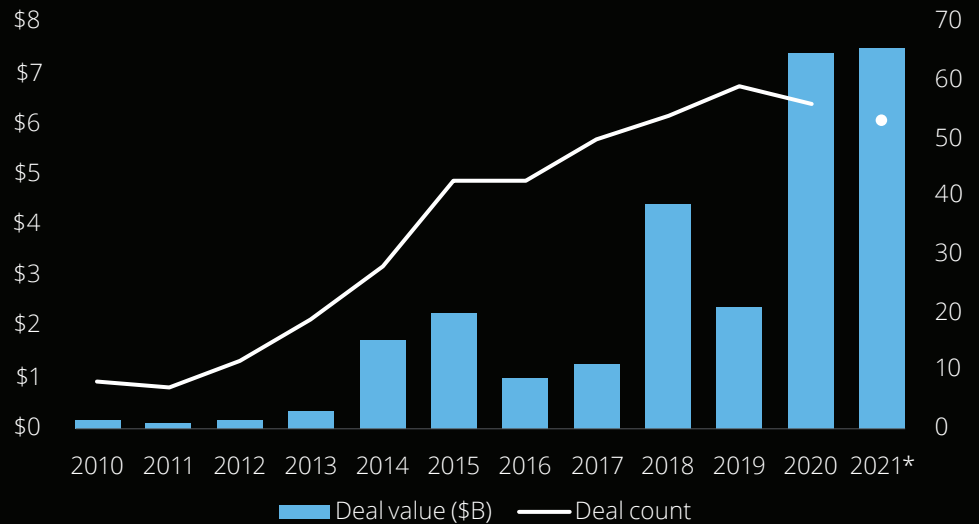
All callouts - Source: PitchBook
Geography: US

"As companies shift into hybrid work models, there has to be alignment across all levels of the organization to prevent cultural divides, departmental differences, and employee dissatisfaction, especially around fairness, as companies adapt to new compensation models and the tax implications across jurisdictions."

Heather Gates

Audit & Assurance Private Growth Leader
Deloitte & Touche LLP

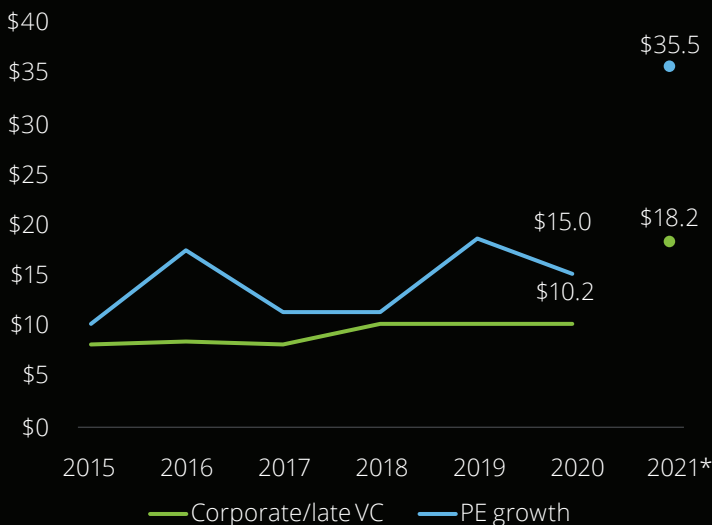
Enterprise software expansion-stage deal activity with expansion-stage company participation



Source: PitchBook | Geography: US
*As of June 30, 2021

Note: These expansion-stage financings had at least one expansion-stage company participate as an investor.

Median deal size (\$M) for enterprise software expansion-stage companies



Source: PitchBook | Geography: US
*As of June 30, 2021

Median revenue (\$M) for enterprise software expansion-stage companies



Source: PitchBook | Geography: US
*As of June 30, 2021

Spotlight: Tax considerations

As hybrid to full-remote work models proliferate, tax implications are deepening

The growing adoption of both hybrid and full-remote company operations is a vector for change that will only further emphasize and expand tax implications for many enterprise software companies, if not all tech companies. Taxes that explicitly target the digital economy as governments grapple with its unique features are more in vogue perhaps than ever before. In October 2020, the Organization for Economic Cooperation and Development (OECD) released Pillar One and Two proposals, aiming to finalize consensus among the 130+ member countries by the middle of this year.³ As of July 1, the organization had agreed to the two-pillar solution and had shifted to devising an implementation plan, to be finalized by October 2021. As some countries have already proposed or enacted unilateral digital service taxes, it behooves tech companies—in fact, any company with digital activities—to begin preparing for how tax regimes may shift and have a significant impact on their bottom lines. Companies will need to actively monitor issues such as whether B2B is going to be increasingly taxed, much like consumer offerings are currently, based on jurisdiction of sale versus origin or both. For example, a change introduced in the Tax Cuts & Jobs Act in 2017 will go into effect in 2022 and require firms that invest in R&D to amortize these costs over five years, starting with the midpoint of the taxable year in which the expense occurs; for research outside the US, costs must be amortized over 15 years. This



amortization will have an impact on investment decisions as companies can currently deduct those expenses immediately.

As for remote workforces, there is active debate about how distributed options may complicate compensation as well as financial reporting pertaining to headcount for companies. Even between US states, the disparity between taxable presences created by a distributed, remote workforce can imply significant preparation and investment into financial department resources. However, the additional work is prompting executives to further invest

into tax-specific software and service packages to help augment internal controls and reduce friction plus manual inputs. Risk management in particular remains a critical focus. As the specter of more unified, higher corporate taxes—maybe even a global minimum tax—looms, businesses of all sizes will need to plan ahead and invest in the key enterprise software tools needed to revamp their tech stack. This may provide further growth for enterprise software companies, but they will also have to reckon with the challenges brought into play with innovative, hybrid working models.

"Existing service providers that have transitioned to platforms will have to reexamine tax liabilities."

Mark Chao

Managing Director, Multistate Tax Practice
Deloitte Tax LLP

"Tax definitions have now finally caught up to digitization of B2B services in particular."

Gordon Perl

National and Silicon Valley Tax Leader for the
Emerging Growth Practice, Deloitte Tax LLP

"Unexpected taxes coming due can be much more painful as such payments are real cash and can also impact liabilities on the financial statements of the company."

Heather Gates

Audit & Assurance Private Growth Leader
Deloitte & Touche LLP

3: OECD (2020), Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint: Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.

Methodology

Geographical region: United States

Sector: The enterprise software sector determination is based on the extant PitchBook verticals of business/productivity software and automation/workflow software.

Capital overhang: Calculated as the sum of capital yet to be deployed that is available for investment. This report includes US-based VC and PE growth funds.

Cash flows: Aggregate capital called (known as contributions) by funds and aggregate capital returned (known as distributions) to LPs from funds by year. Only cash flows from US-based VC and PE growth funds are included in this report.

Assets under management (AUM): Aggregate dry powder (uncalled capital), as well as aggregate NAV (net asset value, i.e. the value of underlying fund investments) by year. AUM is restricted to US-headquartered VC and PE growth funds.

Active investors: The number of active investors is calculated by including either investors who have raised a venture or growth fund in the trailing five years, or those who have made four or more VC or PE growth investments in the past three years. There is no exclusion on investor type apart from angel investors. All investment data is restricted to late-stage VC, PE growth, or corporate financing types as defined by PitchBook.

Nontraditional investors are defined as hedge, mutual, or sovereign wealth funds.

All exits are defined by PitchBook's primary exit types: buyouts, acquisitions, or IPOs. The underlying companies are those that have at minimum achieved any of the investment data under restrictions.

Company inventory is calculated by tallying the number of companies that achieve either late-stage VC, PE growth, or corporate financing by year and have not recorded an exit event as of the year in question.

All exits unless otherwise noted were made by companies that fall under aforementioned criteria for expansion-stage companies. The number of sellers was based on the count of investors classified as PE by PitchBook within the IPO event.

This report was written at the end of July 2021. All data is as of June 30, 2021.

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