VRC

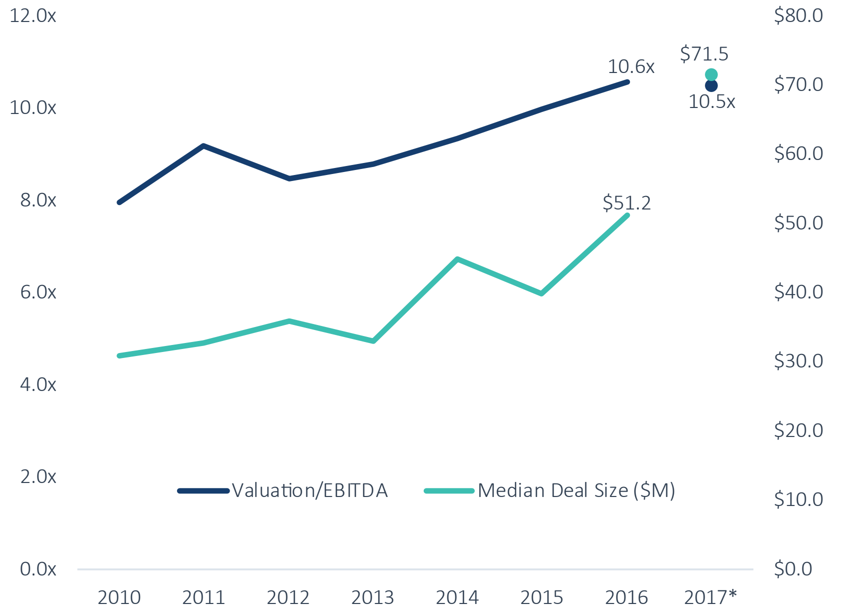
The Maturing Tech M&A Cycle

Data provided by

PitchBook

Steady rises in multiples and deal price tags, with the former culminating in a plateau between 2016 and 2017 to date, speak to the maturation of the overall M&A cycle

Median US M&A transaction multiple & size ($M)



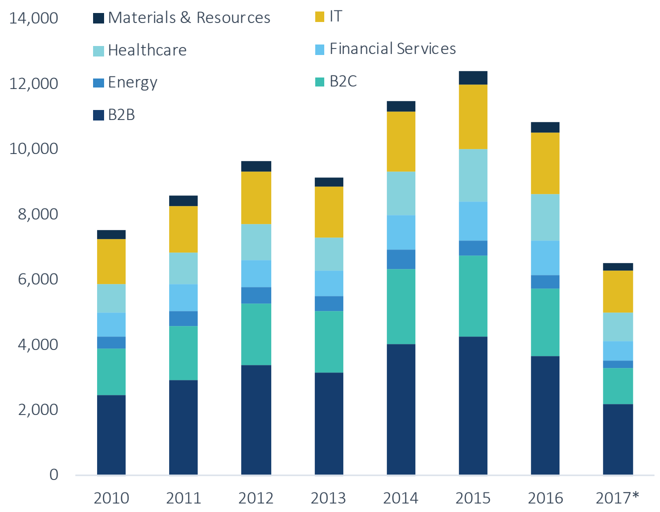
Source: PitchBook
*As of 9/30/2017

In early November 2017, Broadcom announced an acquisitional overture of rival chipmaker Qualcomm for no less than $130 billion all told. Should it go through, that transaction would be the largest pure-play technology acquisition in history.

M&A in the U.S. has been getting pricier over the past few years on the whole. However, between 2016 and the first nine months of 2017, transaction multiples have leveled off, even though median deal sizes soared once more to a new high. In tandem with diminishing overall M&A volume, these recent developments imply a decline in the supply of targets even as demand remains high. For IT in particular, the cycle has been extended.

IT stayed more resilient in volume until this year

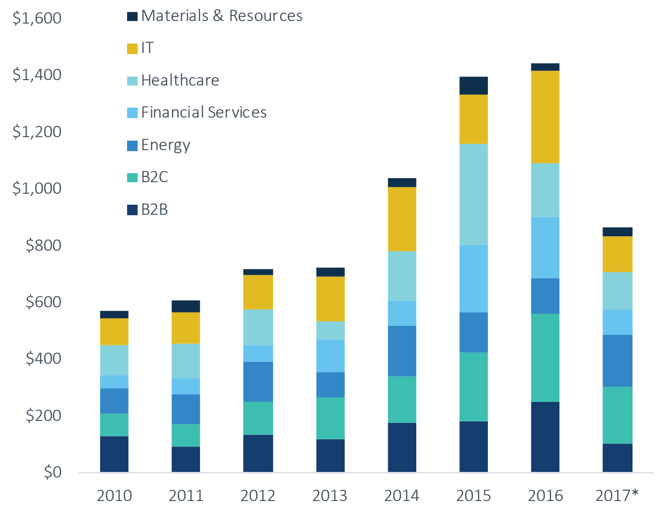
US M&A (#) by sector



Source: PitchBook
*As of 9/30/2017

Mega-deals have boosted IT's proportion

US M&A ($B) by sector



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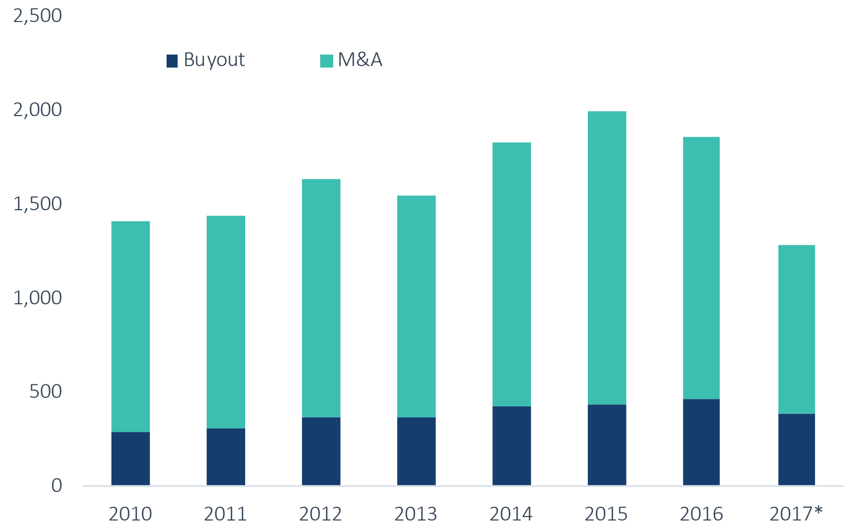
Driven by the incidence of mega-transactions such as the Dell-EMC merger, aggregate IT M&A value surged last year, but what is more telling is the resilience of volume within the sector. Consolidation is still proceeding apace—as exemplified most dramatically by the potential Broadcom-Qualcomm merger—and underpinned even more strongly by the entrance of financial acquirers into the tech M&A arena.

Buyout firms such as Francisco Partners, Thoma Bravo or Vista Equity Partners have long focused primarily on technology, but more and more fund managers are getting in the game. In fact, PE investors are remaining so active that they have accounted for an ever-growing share of IT M&A in the U.S., proportionately speaking. As the software space in particular matures, widespread adoption of the SaaS business model, predicated on recurring revenues, became ever-more applicable to traditional PE operating theses. In addition, as software applications proliferated, blurring traditional sector demarcation, many businesses simply became more prime targets for PE buyers. Last but not least, PE firms have a veritable mountain of dry powder to invest, while supply of worthwhile targets is hardly unlimited; their sourcing scope was bound to expand to wherever seemed most feasible. Accordingly, PE firms are engaging avidly in rolling up fragmented IT niches, as the overall IT M&A cycle continues to mature.

Buyout shops continue to bolster overall IT M&A activity

US IT M&A (#) by acquirer type



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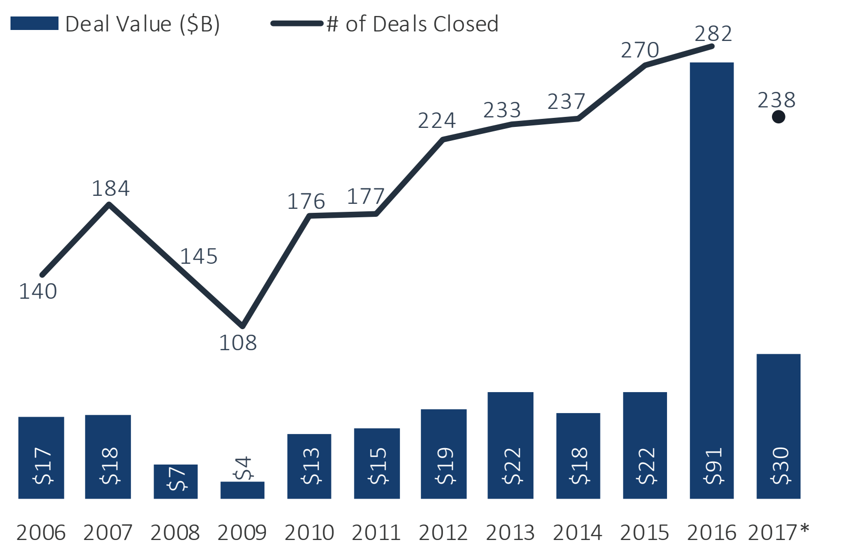
Much of the resilience in IT buyouts can be chalked up to add-ons

US IT PE add-ons



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About VRC

Valuation Research Corporation is a full-service, independent, global valuation firm focusing exclusively valuations that offer judgment beyond modeling. The result provides an accurate and customized view of the value of a business. Since 1975, VRC's network of over 1,200 valuation professionals has provided objective, supportable conclusions of value to domestic and international clients. VRC has locations in Atlanta, Boston, Chicago, Cincinnati, Milwaukee, New York, Princeton, San Francisco and Tampa; as well as international affiliates in Argentina, Australia, Brazil, Canada, China, Colombia, Germany, India, Luxembourg, Japan, Mexico, Singapore, Spain and the United Kingdom.

Justin Johnson, CFA

Co-CEO & Senior Managing Director

Mr. Johnson has more than 20 years of financial and valuation advisory experience. This experience includes providing fairness and solvency opinions as well as considerable experience conducting valuations for M&A, investment, financial reporting, tax and litigation purposes. Mr. Johnson also has significant experience serving private equity clients and private equity portfolio companies. He has worked with well-known firms such as Accel-KKR, Altamont Capital Partners, Francisco Partners, Golden Gate Capital, Leonard Green & Partners, Vector Capital and Vista Equity Partners.

Prior to joining VRC, Mr. Johnson held positions with Arthur Andersen, Merrill Lynch and PricewaterhouseCoopers.

Mr. Johnson holds the designation of Chartered Financial Analyst (CFA) and Accredited Senior Appraiser (ASA). He is also a Certified Public Accountant (CPA), Accredited in Business Valuation (ABV). Mr. Johnson is a member of the CFA Institute and the CFA Society San Francisco. He is also a member of the American Society of Appraisers. Mr. Johnson holds degrees from Brigham Young University in Accounting and Mandarin Chinese.

PJ Patel, CFA, ASA

Co-CEO & Senior Managing Director

Mr. Patel is co-CEO/senior managing director and is a member of VRC's Board of Directors. Mr. Patel specializes in the valuation of businesses, assets and liabilities for financial reporting purposes.

Mr. Patel is a frequent presenter on valuation issues for financial reporting purposes and has recently presented on valuation issues relating to ASC 805, ASC 350/360 and ASC 820. In addition, Mr. Patel was on the Fair Value panel at the 2008 AICPA SEC Conference. He has been quoted numerous times in the press regarding valuation issues. Mr. Patel is an active member of the AITF. He is a member of the Appraisal Foundation's Working Group preparing an industry Practice Aid for valuing customer related assets.

Mr. Patel holds the designations of chartered financial analyst (CFA) and accredited senior appraiser (ASA). In addition, he holds a bachelor of science degree from the University of Toronto, and a master of business administration degree from Canisius College.

Q+A

What is your current take on M&A activity within the US right now? There's talk of the buying cycle winding down—do you agree?

Justin: On the PE side, we've seen a little slowdown in overall volume, but activity by and large still seems strong. Especially in terms of add-ons, there are still plenty of those, which has kept aggregate buyout activity stronger.

PJ: Based on historical levels, we're still seeing strong activity, with an increase in larger carveout transactions relative to two or three years ago.

As is common toward the end of the cycle, there can still be fairly high-priced valuations, although initial North American figures seem to have slid slightly from the heights of 2016. What are you seeing in the market?

Justin: In terms of multiples, valuations are high, there's no question about that. But if you go back to the dot-com era, we still aren't seeing multiples or valuations as high as we observed back then. Again on the PE side, as they perform these add-ons, the multiples are highly discounted versus what we'd see for publicly traded companies, even in the same industry.

PJ: Platform transactions appear to be selling for a premium. But for add-ons, single product lines, and smaller companies in general, there's not quite as much interest and therefore prices tend to be lower.

From your perspective, especially in the current environment, what are the key elements for dealmakers to prioritize when they embark on the valuation process?

Justin: It varies depending which part of the M&A market you are looking at, between PE and public acquirers. On the public side, with the market where it is right now, public companies have to be careful about valuations and what they'll pay for a target, especially assessing the benefits of the synergies they anticipate playing out. Another issue we see when the market gets to this pitch is the prevalence of investment bankers' incentives—which are of course geared toward fees based on transactions and not losing the deal—not aligning as well with those of corporate development teams as much as they should.

PJ: I concur with Justin's remarks overall, with one addition. Given the dearth of targets available, the time to close is actually shorter than what we've historically seen. What we see today is that due diligence processes can be abbreviated, with the gap between seller and buyer expectations being bridged by earnouts or shared risk. If you're talking lower-middle-market deals, where the target isn't necessarily a PE-backed company, you definitely see much more incidence of earnouts. In this seller's market, where there aren't many targets, sellers can ask for anything they want. One of those asks can be: "How quickly can you close?"

Justin: I'll touch again on the comment about how i-bankers' role varies between public and private markets. Public companies especially rely on i-bankers to bring them deals, even given their internal corporate development groups, and consequently i-bankers work with them throughout that entire process and are instrumental. On the PE side, however, there's a very different role for i-bankers in general; PE partners are in the market all the time, so they frequently are cognizant of what's going on in terms of prospective deal flow.

Especially in the current environment, how have valuation approaches needed to adapt to the growing incidence of private-market transactions?

Justin: Acquirers need to look at deals very carefully. Most deals don't end up being good transactions for the public acquirer over time, meaning they don't end up being accretive for their stock. Acquirers need to do a disciplined valuation analysis—err on the side of being conservative in analysis when it comes to synergies.

PJ: I'd add a continued focus on fundamentals is key. You simply have to be more careful in this environment. Furthermore, one must really nail down when the transaction becomes accretive, especially for public acquirers.

Justin: On the PE side, not much has changed when it comes to valuation methods. In the technology space, software in particular, valuation approaches typically emphasize revenue multiples and the recurrence of revenue in general, in addition to traditional EBITDA multiples. Particularly if the target is underperforming on its margins relative to its industry or targets, we'll frequently see a greater emphasis on revenue multiples.

What are the most common erroneous assumptions prospective acquirers make as they approach deals in an expensive environment?

Justin: I'd say our biggest role right now is playing devil's advocate and ensuring the deal receives the proper scrutiny. Not overplaying potential synergies is important, especially at this stage of the M&A cycle. So it's not so much there are new issues, but that we have to play devil's advocate.

PJ: Just to add to that, it's especially important in working with public companies—their cost of capital versus expected return on a transaction. Secondly, is the timeline around expected realization of synergies realistic or optimistic?

What are your thoughts on the increased incidence of secondary buyouts and leveraged recapitalizations in the current market?

Justin: We have seen an increase in sponsor-to-sponsor transactions for purposes of liquidity, with some PE groups taking an enterprise through one phase and then selling to another, or a PE firm selling a majority interest but keeping a minority for any subsequent upside. Leveraged dividend recapitalizations have also increased over the last several years, as PE groups look to obtain partial liquidity during the holding period. There are many reasons for PE fund managers to do this—in the past, if a company didn't have a clear exit and had been held for three to five years, dividend recapitalizations were more of an interim solution. But now they are more a matter of course. Even if a company is successful or as little as two years into its hold period, PE investors may consider a dividend recapitalization regardless of their ultimate exit strategy.