Q2 2018 TECHNOLOGY SPOTLIGHT
M&A trends and private equity deal activity
"Too many investors still view costs related to cybersecurity as discretionary, and may even reduce spending, shockingly."

David Van Wert, Partner in Transaction Advisory Services
The technology industry is in the later innings of a broad innovation cycle, while the dealmaking cycle is still running hot, in a common concurrence. The incumbent tech giants—Amazon, Facebook, Netflix, Apple, Alphabet and Google (FAANGs)—continue to enjoy monolithic positions in their core markets, yet their primary product lines remain by and large the same while they seek to access new markets. Across the globe, Baidu, Alibaba and Tencent (BAT) hold much the same position in China and, increasingly, beyond its borders. Consolidation is still running rampant across the market, bolstered by the incumbents' efforts to stay abreast of technical developments. “Buyers are always looking for ways to accelerate top line growth, particularly for recurring revenue streams,” says David Van Wert, partner in transaction advisory services at RSM US LLP. “Ideally, operating expenses follow an inverse relationship through cost rationalization, restructuring and synergies from combining with another company at the time of acquisition or through add-ons.”

In the end, technology is an enablement of traditional methods of doing business, and as applications proliferate, software continues to eat the world, to borrow Marc Andreessen’s famous phrase. However, as software continues to replace the lower rungs of automated tasks, the innovation cycle is slowing, as hardware catches up and more difficult technical challenges, such as more sophisticated artificial intelligence (AI) programs to help thwart cyberattacks automatically, persist. Advances are being made, but for now, the continued consolidation in key segments, as well as amount of capital flooding into dealmaking and venture investment, signal that the next innovation cycle is largely in its early stages. The main trends for the middle market, in particular, are currently consolidation, integration and increasing private equity (PE) buyer activity, and this state of affairs does not look set to change anytime soon.
Cybersecurity is an issue that affects all companies to varying degrees, but for tech companies in particular, it is a critical area of concern. Depending on the company, there could be significant exposure to threats on multiple fronts. To take one particularly dramatic example, hospital systems being held ransom could well occur again, as troubling as that is. Other companies that operate repositories of data for, say, PE portfolio companies, as well as PE firms themselves, could also prove suitable targets for attackers as they could yield richer payoffs given greater stores of data. “Savvy investors understand that having a detailed cybersecurity plan that has both proactive and reactive aspects is essential to avoid events that could be potentially very harmful financially and operationally,” says Van Wert.

It should be noted that large companies aren’t the primary targets alone; middle market companies are just as much at risk. In partnership with the US Chamber of Commerce, the RSM US Middle Market Business Index Cybersecurity Special Report highlights how middle market companies are increasingly landing in the crosshairs of cybercriminals, with the number of middle market companies reporting breaches nearly tripling in the last three years. A few additional key findings in the report include:

- A large number of middle market executives (47 percent) indicate an attempt to illegally access their data or systems is likely—a significant increase over just two years ago (39 percent).
- Some of the top cyberthreats concerning the middle market include ransomware and social engineering.
The narrative of synchronized global growth is shakier than ever, as troubling macrofinancial trends among sovereign debt loads and contentious political topics such as trade, not to mention China’s uncertain path forward, are all combining in a potent mix. That said, such an environment may only encourage mergers and acquisitions (M&A) even further, as companies look to get deals done now before additional and potentially negative factors come into play. The ceaseless rise of equities continues to fuel M&A among tech companies to a significant degree as well. Thus, from a macroeconomic perspective, the tech M&A cycle looks primed to remain resilient.

When it comes to dealmaking conditions, however, the level of multiples being paid within the marketplace for tech companies, particularly those with recurring revenues that can justify significant, forward-looking revenue multiples, could dissuade would-be acquirers at some point. “Pricing remains high,” states Van Wert, “propped up by highly competitive auction processes.” PE buyers will continue to prop up volume, but focus on the smaller end or middle segment of the market, barring the occasional growth equity stake such as the recent $400 million investment in marketing company AppLovin by KKR. Accordingly, volume may diminish somewhat going forward, even as aggregate deal value remains robust given inflated multiples, but remaining within historically strong levels. “It’s a sellers’ market; and in addition to record multiples, sellers are demanding shorter processes,” says Alex Weiss, partner in transaction advisory services at RSM US.
Cybersecurity best practices for PE firms, even those in the middle market, are imperative given their concentration of valuable intellectual property.

47 percent—a two-year increase of 8 points—of middle market executives indicate an attempt to illegally access their data or systems.

Ransomware and social engineering: Some of the top cyberthreats concerning the middle market.

Where are PE firms searching for value now? After it deal value slumped once again, PE firms are targeting the lower middle market.

Median PE deal size remains stubbornly low at $66.7M.

Technology M&A activity slides in Q2, propped up by PE, as prices take a toll.

At $548.7M, average Q2 IT M&A transaction size was one of highest on record.

PE buyers still propping up IT M&A volume.

IPO

Friendlier exit environment delivers a resurgence in IPO volume.
A ROBUST FIRST HALF

At $132.5 billion in the second quarter of 2018, across 734 transactions, the M&A cycle in technology remains well within historic medians—a mild increase in the tally of completed transactions is to be expected in coming weeks as additional data is gathered. North America still accounts for the bulk of M&A activity, but Europe has seen much more stable deal volume overall, interestingly, after a gradual decline from the heights of the first half of 2017. This is likely attributable to macroeconomic conditions taking an initial toll on European M&A, which since then has achieved an uneasy stability.

“Preparation is key,” says Weiss. “Auction processes result in a high volume of buyer inquiries and requests while shorter timelines are forcing buyers to front load due diligence.”
A STARK DOWNTURN AFTER A PEAK

Interestingly, after a record quarter, the median M&A transaction size plummeted in the second quarter of 2018. Given it is now back within historic ranges, such a turn suggests that the first quarter of 2018 and the final quarter of 2017 were outliers, experiencing significantly inflated deal values.

MEDIAN IT M&A SIZE ($M)
EVEN AMID DECLINE, PE FIRMS PROP UP VOLUME

Despite a slight decline in volume from a peak in the final quarter of 2017, PE firms are still more active than before, to the extent that they are accounting for over 30 percent of all aggregate M&A activity for only the second quarter ever. Interestingly, growth transactions remain well on pace to match or even barely exceed a record 400+ tally notched in 2017, which is likely due to an increase of new entrants to the sector and diversification of strategies for exposure in a competitive marketplace.
In an effort to avoid overpaying, PE buyers are sourcing lower in the middle market, predicating pricey purchases on additional expansion and sustained recurring revenues. The focus on software is highly apparent, although even its rate of proportional growth is surprising over the past few years. Such a trend makes sense in the context of industrywide trends, however, as even more companies continue to shift to cloud-based services.

**Source:** PitchBook

*As of June 30, 2018*
A DIP AFTER A RECORD RUN

Throughout 2017 and into the first quarter of 2018, the proportion of add-ons in information technology was remarkably high and resilient, a testament to both heightened PE interest as well as their approach to cutting deals in a competitive, crowded and costly environment. The recent dip may be more of a quarterly outlier than anything else, as the proportion remained relatively high on a historical basis; broader trends certainly indicate that PE firms’ enthusiasm for adding on technology companies is unlikely to wane.
THE VALUE OF RSM'S MIDDLE-MARKET LEADERSHIP

Focusing on the middle market, RSM US provides integrated transaction advisory, tax, assurance and consulting services. Our work with 1,300 technology companies gives us a deep understanding of the key trends impacting the industry. In addition, we have performed due diligence on more than 2,200 deals in the past five years, over 150 of which were technology company transactions. This in-depth knowledge provides our private equity and strategic buyer clients with industry-specific due diligence considerations.