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Information Technology

PERSPECTIVES ON THE REAL ECONOMY

By Joe Brusuelas, RSM Chief Economist

The growth path of the U.S. economy late in the business cycle has slowed and the rate of expansion will do well to reach 2 percent on an annual basis even after what is shaping up to be a modest rebound to near 2.5 percent growth in the second quarter. The RSM US Middle Market Business Index rebounded to a cyclical high of 129.8 in the first quarter, a reflection of business optimism related to the possibility of significant corporate tax reform and the Trump administration’s proposed spending plan.

The combination of slowing productivity and demographic headwinds have caused the long-term growth path to ease to 1.5 percent per year, down from 3.3 percent per year growth a decade ago. Despite a fairly bright consumer outlook—our forecast is for household spending to increase at a 3 percent pace this year—there remains the potential for significant retrenchment if policymakers fail to deliver on tax and spending promises.

Mergers and acquisitions

The term structure of interest rates is not yet particularly favorable to mergers and acquisitions (M&A) activity. While we anticipate the Fed will lift rates by a minimum of 50 basis points this year, the combined impact of safe haven moves into dollar-denominated positions and chasing of yield by international investors continues to suppress rates at the long end of the curve. Thus, conditions remain in favor of sellers as opposed to buyers in the market.

Information technology

The U.S. dollar has depreciated as investors have breathed a sigh of relief with respect to the fading of political risk in Europe and improved growth in the EU, China and emerging markets. This has led to a temporary halt to the USD’s three-year bull run, despite the likelihood of the US central bank hiking rates by an additional 50 basis points this year. While demand for consumer electronics is flat on a year-ago basis, outlays for those goods increased 2.2 percent in March and 1.3 percent in April, which points to a likely mid-year expansion in consumption.

OTHER RESOURCES

The Real Economy

A monthly publication to help the middle market anticipate and address the unique issues and challenges facing their businesses and the industries in which they operate. We also release a Global Edition on a semi-annual basis that addresses issues affecting business on a global scale. Read more.

The RSM Middle Market Business Index (MMBI)

The RSM Middle Market Business Index developed in partnership with Moody’s Analytics, is designed to accurately reflect business conditions in the U.S. middle market, while providing a statistically significant measure of the health and outlook for these businesses. Read more.
Sentiment around IT M&A remains bullish

- Competition remains high in the information technology (IT) sector as software continues to eat the world and blur the intersections between classical business lines and new technologies.

- Unlike many other major sectors, the volume of M&A was actually up between Q4 2016 and Q1 2017, if more muted on a year-over-year basis.

- Buyers seek to differentiate what they bring to the table by emphasizing swifter closing times, shorter exclusivity periods and less intrusive shakeups to current operations, among other features.

- Despite the narrative around the tech IPO window opening, RSM industry experts still see M&A as the surest route to a sale for many businesses.

- Recurring revenue is increasingly the name of the game, although it is not an easy transition for all, tied as it is to the transformation of the industry to focus on cloud-based offerings.

- The tenor of political debate and general uncertainty still is a concern for many, particularly when it comes to the pool of available talent.

- The median IT buyout size hit nearly $101 million in Q1 17, the highest tally of the past decade.
Reversion to the mean

On a global basis, IT M&A volume is not quite at the elevated levels observed for much of 2014 through 2016. That said, it’s not as if the same level we are approaching that was recorded in 2013 was weak, and should current sentiment prevail, the rate of dealmaking could accelerate even further. Moreover, aggregate deal value is still just barely on the higher end historically, as the $69.5 billion in Q1 2017 represents the ninth largest such figure of the past 17 quarters.

“In many ways it’s a continuation of previous trends,” says David Van Wert, partner with transaction advisory services at RSM US. “Deals are certainly getting more competitive. There are many new trends not only within the sector but also in the approaches investors are taking.” According to Van Wert, both new and existing private equity (PE) groups continue to avidly source within the technology sector, with new teams and funds created to focus on the industry and its latest trends. All of this only helps intensify competition. “It’s getting harder to get on deals—’I’ve gotten calls from clients that say they have a potential new deal and then, a week later, they say they have lost out to a new group they had never heard of,’” says Van Wert. Hence the fairly hefty average transaction size, which suggests a disparity in the demand for certain businesses. A note of caution regarding the overall valuation-to-EBITDA multiples should be voiced, but should those numbers hold—particularly the equity–debt ratio—it would seem acquirers are still not only paying elevated prices but also are ponying up more cash to win out in auctions.

Average and median M&A deal size (SM)

Deal multiples

PE stays on the hunt

“The key is to find the more promising technologies or products and sift through companies to go beyond a mere ‘me-too’ approach to investing in IT,” says Robert Burke, technology sector practice leader at RSM US. “You want to find opportunities where the management team doesn’t have the ability to scale. So my clients tend to look at business that have been around a while, that are still modestly sized.” Especially as PE investors must contend with high-priced valuations that could depress future returns, careful heed in diligence combined with eagerness to cut deals could contribute to keep investment at an elevated if steady plateau.

“The generality is that the letters of intent (LOIs) that we have been seeing have shorter exclusivity periods,” says Van Wert. “But then in reality, the fine-tuning of the deal takes longer than expected. So anecdotally it may seem that the transaction is set to move faster, but actual closing is stretched out. In terms of timing, all bets are off if it is a highly attractive auction process.”

IT PE deal flow by year in North America

Source: PitchBook. *As of 3/31/2017

IT PE deal flow by year in Europe

Source: PitchBook. *As of 3/31/2017
Just how expensive it’s gotten for PE buyers is well illustrated by the steady increase in the median buyout size over the past five years. It may be tempting to infer the leveling out over the past two years as an indicator of an upper limit, yet given just how much dry powder is in PE coffers and the intensity of demand for exposure to technology companies, there may still be further increases.

“Speed is everything, but with the prices people are paying, it puts a premium on really getting the transaction right,” says Burke. “I haven’t really seen a difference in the types of processes that I have been brought in on. Shortened exclusivity has become more common, but nobody is willing to surrender basic financial due diligence or tax compliance review.”

Van Wert can attest to at least one case where the scope of diligence was deliberately lessened due to sponsors’ desire to close the deal quickly, even if downside risk grew commensurately.
Information Technology

PRIVATE EQUITY EXIT ACTIVITY

IT private equity exits by quarter

Liquidity via private routes

Contrary to much of what has been observed in other sectors, exit activity actually increased to kick off 2017. Unsurprisingly, that spike in exit volume was driven in part by a surge in secondary buyouts; as PE buyers’ appetites remain keen for IT businesses, there is plenty of opportunity for fellow PE buyout shops to unload businesses in certain cases. Perhaps a larger firm can help more when it comes to scaling, or has additional, specialist capabilities that can address a particular niche need of the business before it can grow to the next level.

“Proposal activity for sell-side diligence has increased significantly year over year,” says Van Wert. “I think there’s still a disconnect in terms of sellers not quite grasping the value of their business. Founder-owned businesses often fall in this category.” According to Van Wert, the sentiment in the market right now is that it is a good time to sell—understandably so, given the valuations and transaction sizes observed—so owners are getting prepared even if a deal process isn’t underway or any concrete offers are on the table.

IT private equity exits by year

IT private equity exits (count) by sector

Source: PitchBook. *As of 3/31/2017
The IPO climate has yet to decisively turn

One outlier debut of a particularly buzzed-about company—Snap, with a massive debut that already puts Q1 2017 ahead of every other in terms of capital raised since 2014 began—is not enough to decisively shift market sentiment. The handful of debuts by other formerly venture-backed, much-publicized companies such as MuleSoft, Cloudera and Okta does more, in fact, enough to get industry pundits salivating, yet when all is said and done, there just weren’t that many initial public offerings (IPOs) in Q1 2017. There are still a few potent factors at play, even if market volatility is currently not apparent: first, other exit alternatives for financial backers and founders are still alluring for their typical traits of speed, generous valuations and more; two, there is a probability that the very lack of volatility or the market’s lack of response to events that normally would induce more choppiness—such as the recent election in France—is still spooking managing teams; and three, staying private can still be more attractive. The scrutiny inherent in being a public company is as uncompromising as ever. As the scant pipeline below illustrates, many companies aren’t prepared officially to brook that particular hurdle just yet. It is more than likely that the pipeline is refilling, especially as macro conditions seem to stabilize somewhat, but for now, it remains to be seen whether 2017 will truly be a turnaround year for IPOs.

IT IPO PIPELINE

<table>
<thead>
<tr>
<th>Company name</th>
<th>Sponsor(s)</th>
<th>Sector</th>
<th>Amount (SM)</th>
</tr>
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<tbody>
<tr>
<td>Altice USA</td>
<td>Altice, BC Partners, Canada Pension Plan Investment Board</td>
<td>Telecommunications</td>
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<tr>
<td>WOW!</td>
<td>Avista Capital Partners, Crestview Partners</td>
<td>Cable Service Providers</td>
<td>$100</td>
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<tr>
<td>Tintri</td>
<td>Silver Lake Management, New Enterprise Associates, Insight Venture Partners, Lightspeed Venture Partners</td>
<td>Software</td>
<td>$100</td>
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</tbody>
</table>

Source: PitchBook
A new high for PE proportions

Kicking off 2017 in impressive fashion, PE buyers bought or sold so many IT companies in Q1 that their portion of overall M&A reached a new high, closing in on 30 percent for the quarter. Whether or not that proportion is maintained, it is a testament to the maturation of the industry as well as evolution of PE fund strategies. IT is simply proliferating into more areas and aging into stages in a company life cycle that traditionally were PE fund managers’ bread and butter. Thus, they come under typical operating theses’ purview while newer funds are also being raised to focus explicitly on the tech sector. It’s worth pointing out that due in part to the level of public market valuations, little of that activity is composed of take-privates—the percentage of public-to-privates driven by financial buyers only continues to dwindle.

SELECT IT Q1 2017 M&A/PE TRANSACTIONS

<table>
<thead>
<tr>
<th>Company name</th>
<th>Buyer(s)</th>
<th>Sector</th>
<th>Amount (SM)</th>
</tr>
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<tbody>
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<td>PlanView</td>
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<td>Teledyne Technologies</td>
<td>Electronic Components</td>
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<td>Trello</td>
<td>Atlassian</td>
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<td>Madison Dearborn Partners</td>
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<td>Insight Enterprises</td>
<td>IT Services</td>
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<tr>
<td>BI-SAM Technologies</td>
<td>FactSet Research Systems</td>
<td>Software</td>
<td>$205</td>
</tr>
</tbody>
</table>

Source: PitchBook
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 500 middle-market technology companies gives us a deep understanding of the key trends impacting the industry. In addition, we have performed due diligence on more than 1,850 deals in the past five years, over 200 of which were technology transactions. This in-depth knowledge provides our private equity and strategic buyer clients with industry-specific due diligence considerations.

The following list shows a detailed breakdown of the PitchBook industry codes for the IT industry.

6. INFORMATION TECHNOLOGY

6.1 Communications and networking
6.2 Hardware
6.3 Semiconductors
6.4 Services
6.5 Software
6.6 Other information technology