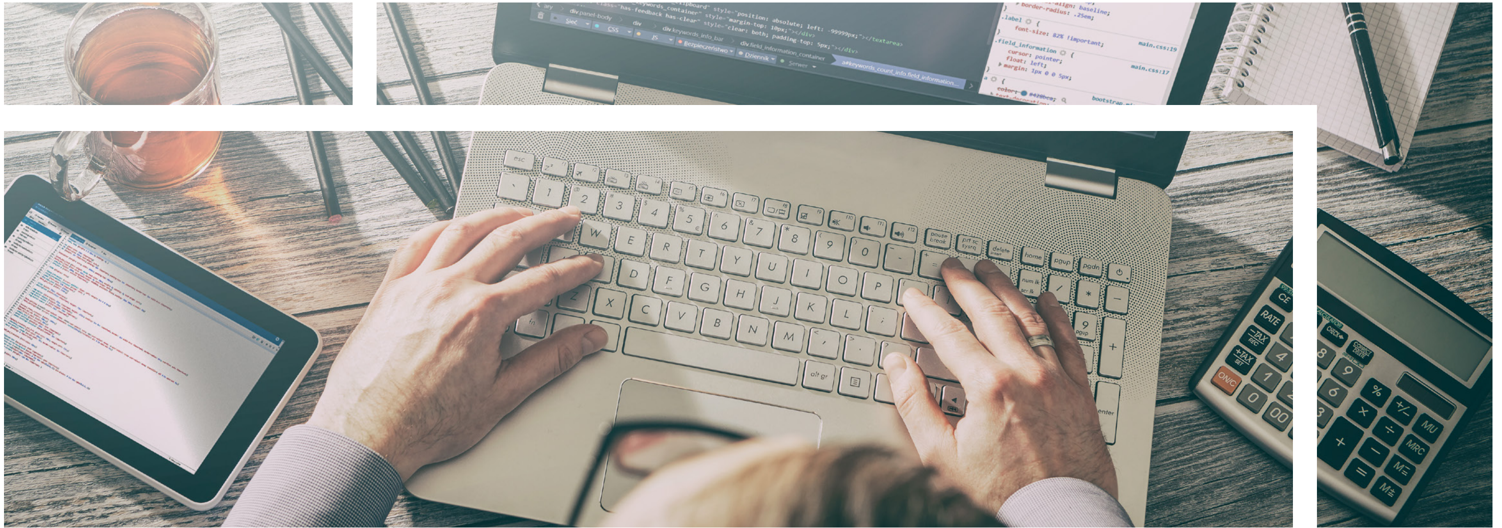
Q&A: How Competition for Software Deals has Changed Auction Process Dynamics in the TMT Space

CONTRIBUTORS
Scott Twibell | Managing Director | New York



WHAT DRIVES DEAL ACTIVITY IN THE TMT SPACE?

Scott: If you kind of step back a little bit, you have had for at least the last three years a very good climate for M&A activity. And you have had a record amount of capital under private equity management. As prices have gone up, software has probably benefited the most, and probably business-to-business vertical software has benefited the most, because you see it sort of proliferating virtually across any other market. It's in industrials today, it's in the things like automotive, in oil and gas, it's in consumer-facing businesses. And you also have, within private equity ownership, more funds today that you've ever had. So what that means is you have more tranches of institutional capital. You have groups solely focused on smaller businesses and making [those businesses] larger; you have another group of PE funds that would be very good candidates to take midsize businesses and build them [bigger], and in the end you obviously have groups like Vista and Thoma Bravo. But things like buy-and-build have mattered a lot, adding businesses to platform businesses over time.

HOW DOES HIGHER COMPETITION FOR ASSETS INFLUENCE AUCTION PROCESSES?

Scott: [One] thing that becomes more clear quarter over quarter, certainly within the PE community, is that [PE firms] have to pick their spot more carefully. Valuations are high. Everyone knows that you're going to pay a lot for quality assets, but you also want to make sure that you have an angle that you can explore. Knowing that it's a super-competitive universe for the folks out there — a lot of people are competing for those transactions — I think people try to pick their spot a little earlier. And if they have conviction that this is the business they want to own, they tend to do more than they historically would to try and get that business. They know that they are going to pay a lot for it ... but there are other things they can do in terms of [increasing] speed to closing the transaction and [in terms] of the efficiency of the diligence process. Things that are not monetary that have become more commonplace now than they were before.

WHO HAS TO ADJUST MOST IN THE PROCESS WHEN BUYERS ARE TAKING MORE RISK TO COMPETE?

Scott: Put aside value for a second. Obviously, you want certainty of the transactions and the timeline of the transaction to be the shortest you can get. I think for buyers it is challenging. Particularly, in the PE universe, if you are a large fund you can use it as an advantage: You have more resources that you can deploy, in terms of putting money towards third-party diligence earlier. And if it doesn't go your way, yes, you lost money, but you didn't lose that much money. [If] you're a smaller fund, it's hard for you to do that repeatedly and not win a transaction. You just simply don't have that many resources to continue to spend money on the diligence processes and then not win an auction. It can be almost a tactic of larger private equity groups against some of the smaller shops.

You just have to pick your spots a little more carefully: whether that's trying to get to know businesses earlier or doing a lot of research in a specific space so you're more educated and therefore maybe don't have to spend that much money up front. You have to figure out ways to offset that.

[This] is more acute in the software space because those auctions have tended to be more robust recently. You're underwriting to really high valuations in the first place, you have more investors than ever before going after software businesses, so you just have a landscape that sets up against funds that don't have the resources to continuously do that and lose.

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DO LENDERS HAVE TO ADAPT TO INCREASED COMPETITION FOR TECH ASSETS, AND HOW?

Scott: The more software businesses you see out in the market, the more those software businesses are priced off forward revenue multiples — that is something that lenders have had to adapt to. Historically, lenders would be much more focused on last 12 months Ebitda. As groups have bought businesses, and particularly software businesses, off of forward revenue multiples, lenders have had to kind of adapt their thinking to how you lend off of things like recurring revenue and trailing Ebitda.

If you take where we are today, people are paying for software businesses on a multiple of what their 2019 revenue will be, not what their last 12 months as of May is. Lenders, in terms of supporting private equity funds to do those transactions, have had to think about what their credit looks like and underwrite towards a multiple of the forward revenue versus trailing cash flow, because there is no trailing cash flow.

It's a pretty big departure, if you think about it. One is lending off of cash flow, one is lending off of forward revenue. I think it is one of the reasons why we continue to see valuations of software businesses stay high, because you're getting more and more lenders that are comfortable with that construct. ... At the end of the day, if you are a lender and you're supporting the PE universe and the PE universe is largely buying software businesses, you basically have to adapt. Otherwise there is another credit fund that is going to adapt.

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WHAT APPROACH FOR GROWING PORTFOLIO COMPANIES WORKS BEST IN SUCH AN ENVIRONMENT?

Scott: If you're paying those kinds of prices for those businesses ... buy-and-build has definitely become more important as a way to get scale in a shorter period of time behind a platform business. But in some ways, it's also a way to bring down the cost of the total investment. You're buying businesses at these high multiples of forward revenue [and] you can later find businesses to do as add-ons to that business. Then, you can bring down the cost of it and you can get the benefit of more scale. This opens up other types of investors as buyers on a forward sale. It opens up lenders in terms of more leverage – this is something we've seen taking a lot more shape and importance in the last two years, than three or four years ago.

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