

# What's Behind the Surge in Software Deals?

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An excerpt from the Privcap webinar “Private Equity and the Software Industry: What’s Behind the Surge in Deals?”

## The Panelists

**Rob McIntosh**  
Autodesk

**Arvinth Kumar**  
Thoma Bravo

**David Van Wert**  
RSM US LLP

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## The Panelists

The race toward digital transformation is driving rapid change in the software space—and that's driving interest from private equity



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In this condensed version of a Privcap webinar, experts from Autodesk, Thoma Bravo, and RSM US LLP discuss what smart investors need to know about the booming private equity opportunity in software, including what the most attractive sectors are, the exit environment, and key drivers of success.

**Privcap: There has been increasing momentum in the number of PE deals being done in the software space. What's driving this deal volume?**

**Arvindh Kumar, Thoma Bravo:** Technology is a high-valuation environment, so prospective sellers are inclined to sell. Also, interest rates are very low, and there's a ton of cheap capital out there. What's more, software as an asset class—and technology more broadly—has really grown compared to other cyclical markets such as energy and retail. As digitization and automation have become more and more important globally, software has played an essential role in that transformation.

**Rob, what are you seeing from your perspective? What's drawing buyers and sellers in today's market?**

**Rob McIntosh, Autodesk:** One big driver of activity, particularly within some of the enterprise software markets, is changing business models. Companies are trying to drive more contemporary business models and platforms.

Certainly there are a lot of startups that are active in developing great new cloud solutions. But in older businesses like Autodesk, we're seeing a big effort toward trying to drive a business model transition—i.e., moving from perpetual software to term-based software—as well as a transition from boxed software products and electronically delivered products to pure cloud-based products. So, within our sector, we've seen a tremendous amount of consolidation as older businesses try to cross that chasm, which requires new talent, new back-end systems, new delivery methods, maybe even new sales channels. Certainly, in older software businesses, that has been a huge driver for their M&A activity.

**David, you talk to a number of clients active in this space. What are you seeing?**

**David Van Wert, RSM:** Technology is now touching pretty much all industries, and that's leading to M&A opportunities, which is resulting in the constant change and disruption that we see. That's just the nature of the technology industry—rapid innovation refills the M&A pipeline.

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There's never a true shortage of good companies out there, compared to some other industries. In other industries, you might see a lull after a surge in M&A, because a lot of the best businesses have already been bought.

**The healthcare software space is particularly active these days. What is the opportunity there?**

**Kumar:** We're seeing four key themes: revenue cycle management, alternate payment models, data analytics, and the post-acute space. On the revenue cycle management side, there's an increased need for productivity and accuracy—for hospitals and providers to get paid faster and have fewer denials.

That gets to the second theme, which is alternate payment models. There's been a shift to value-based reimbursements, so if you have good outcomes as a provider, you can get paid more. If you have bad outcomes and people keep coming back or stay in very expensive settings, you get paid less by insurance companies and by the government. There are a lot of technology companies that help assist in that transition.

Third is data analytics. There are lots of systems in healthcare that don't talk to each other, so lots of data gets lost in translation. It's critical to be able to, first, gather data, second, to understand what it's saying, and then, third, to make it actionable. There are a bunch of companies that can help with that.

Finally, there is the post-acute space. Inpatient hospitals are trying to shift to lower-cost settings post-acute. So they're expanding care across the continuum into home health and into building nursing facilities and long-term care facilities. There's an aging population with chronic conditions who need to be cared for in an increasing volume, given the baby boomer phenomenon. Having healthcare technology systems that can help address that has become an increasing focus for healthcare investors.

**There is also growing interest in cybersecurity. David, can you talk a little bit about that opportunity?**

**Van Wert:** Cybersecurity is in the headlines on a daily basis, most recently with the Russian hacking of the DNC [Democratic National Committee]. I think all of that creates a lot of hype

and brings new entrants into the market. One interesting trend that we've been seeing is that cybersecurity companies are also becoming targets, just because of the confidentiality, of the information they have access to. That can be extremely damaging to the reputation of the business, and it can also crater a business whose core competency is cybersecurity. I'd liken it to the front page of the *Wall Street Journal* saying, "David Van Wert doesn't know how to balance his checkbook." I think that would be extremely damaging to my reputation as an accountant.

Just given the threat to some of these cybersecurity businesses, that leads to additional risk to corporate acquirers or private equity acquirers that are looking to invest in these types of businesses. You don't want to take on a time bomb or a land mine. Also, from an M&A perspective, there has been a lot of froth in the market for security. There has been significant activity and high multiples. And given all the new entrants, I would expect that there will continue to be very active M&A activity in the cybersecurity subsector. But I think we will see the best businesses being acquired, and a lot of the pretenders that have gotten in just jumping on the bandwagon will be falling off.

**What about older software companies looking to adopt new models? What is the opportunity, and what types of companies are doing this?**

**McIntosh:** Anybody who follows [Wall] Street can see that companies on a term-based pricing model are typically more highly rewarded. It's a good model for shareholders, because it's a more reliable business model. It also ends up being the right model for your customers, because you're able to provide a more minimal upfront capital investment. We've seen a number of companies starting up and entering our space and others, because the cost to create these companies is lower than it's ever been before. Startups can leverage platforms like ours or Salesforce ... to get to scale a lot faster than they could if they were to build a traditional enterprise software company.

**What does the deal environment look like today in terms of buyers and sellers?**

**Van Wert:** Given that multiples are still very high based on historical averages, the market is very

attractive to sellers. One thing that is probably keeping buyers and sellers apart is the lack of preparedness among sellers. Sellers might say, “Yeah, we’re going to get a great multiple here and a great purchase price.” But they haven’t really done the blocking and tackling to prepare for a sale. We’ve seen the technology industry lag other industries in adoption of sell-side diligence. In terms of who’s really calling the shots in a deal, I would say any transaction is a negotiation, when it comes down to it. And it probably depends on what type of deal you’re talking about. For instance, a seller probably has much more negotiating power if it’s a non-exclusive auction transaction versus a proprietary deal versus maybe a minority investment, where it truly is a partnership going forward and no one wants to draw blood from the other party during the transaction.

**Arvinth, what are you seeing in the deal environment?**

**Kumar:** It’s pretty bifurcated. On the one hand, we’re seeing very high-quality private companies not traded in the public markets. There’s a scarcity of good assets out there—companies with a lot of recurring revenue, very high retention rates, stable end markets, pricing power, high EBITDA margins, high growth margins. There’s not that many of them, especially in the size range that we transact in. So there’s a supply/demand imbalance. On the other hand, on the public side there have been a bunch of transactions where companies came out with very hot IPOs but were not mature, not super well-run, and they keep missing quarters of earnings. So we’ve seen a huge amount of growth in take-privates by activist investors just because of poor guidance and missing numbers consistently.

**Rob, can you talk about the deployment of capital and what’s driving volume?**

**McIntosh:** Traditionally, we haven’t seen a lot of private equity players involved in our space. Maybe the attractiveness of the sector is increasing, but it used to be that when we came to bid on a deal, if a private equity player was involved, they typically couldn’t move that fast or they just

had tertiary interest. But recently we’ve seen private equity players coming in and bidding much more than the strategics. Maybe my sample set is small, but I probably had five to 10 transactions in the last year where the sponsors were outbidding the strategics—in some cases by a factor of two-to-one. So it does seem like there’s some amount of capital overhang here that’s driving activity.

**As an investor, how do you protect yourself in a market like this with high valuations and a lot of competition for deals? How do you make money?**

**Kumar:** It’s tough. We’re seeing a lot more competition [from] tier-three-type sponsors that haven’t been in software technology trying to get in, and they’re just overpaying, which they know and we know. We only buy the right assets where we can add value through operational improvements. These are companies that have very high revenue quality, but are just not managing the business the right way. We also try to focus on companies that have a fragmented end market where we can do M&A to either extend product lines or buy competitors or go into new geographies. And that adds more earnings that you can borrow more against. Software has great characteristics in that respect.

**What is the outlook for 2017?**

**Van Wert:** Particularly in the technology industry, you will continue to see the large blockbuster transactions and the larger take-private deals, once the frothiness in the public market dips a little bit. And then, on the flip side, you’ll probably see a lot of add-on acquisitions as current holders try to bolster up their portfolio companies and really fill the gaps in terms of technology or sectors or region.

**McIntosh:** It’s been a pretty robust almost three years, at this point, but I don’t see it necessarily slowing down, at least not in massive ways—maybe a little bit here and there. And there could be an influx of M&A activity if corporates are able to repatriate cash to the U.S., as well. That would fuel even greater M&A activities, particularly domestically. ■